[JOINT COMMITTEE PRINT]

IMPACT ON SMALL BUSINESS OF REPLACING THE FEDERAL INCOME TAX

SCHEDULED FOR A HEARING

BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON APRIL 24, 1996

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

APRIL 23, 1996

U.S. GOVERNMENT PRINTING OFFICE

23-902 WASHINGTON : 1996 JCS-3-96

For sale by the U.S. Government Printing Office
Superintendent of Documents, Mail Stop: SSOP, Washington, DC 20402-9328
ISBN 0-16-052563-2

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104TH CONGRESS, 2D SESSION

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ERRATA FOR JCS-3-96

- On page 68 (Table 9), the headings for columns five and six should be transposed (i.e., the heading for the fifth column should be "500 or more" and the heading for the sixth column should be "Number of firms").

- On page 118 (Table A-15), the last number in the column "Number of returns" for the second portion of the table (Firms classified by gross receipts) should be: 59.

- On page 120 (Table A-17), the heading for the table should read:

Table A-17.--Distribution of Partnerships, 1993:
Agriculture, Forestry and Fishing

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on April 24, 1996, on issues relating to the impact on small businesses (including start-up companies) of replacing the Federal income tax. The hearing will focus on the effects of the following possible proposed replacement tax systems: (1) a national retail sales tax, (2) a value-added tax, (3) a consumption-based flat tax, (4) a cash flow tax, and (5) a "pure" income tax. Some of these proposals have been the subject of introduced legislation. On March 6, 1996, Messrs. Schaefer, Tauzin, Chrysler, Bono, Hefley, Linder, and Stump introduced H.R. 3039, the "National Retail Sales Tax Act of 1996." On May 26, 1994, Senators Boren and Danforth introduced S. 2160, the "Business Transfer Tax," which is a subtraction-method, value-added tax. On July 19, 1995, Mr. Armey and Senator Shelby introduced H.R. 2060 and S. 1050, respectively. These bills provide consumption-based flat taxes. On April 25, 1995, Senators Nunn and Domenici introduced S. 722, the "USA Tax Act of 1995," which contains two consumption-based taxes—a cash flow tax on individuals and a subtraction-method, value-added tax on businesses. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes several aspects of present law and the various tax restructuring proposals with respect to small businesses, start-up companies, and firms engaging in research activities.

Part I of this pamphlet is an overview of the discussions contained in the remainder of the pamphlet. Part II provides a description of certain present-law income tax provisions that apply to small businesses, summaries of the various proposed replacement tax systems, selected data with respect to small businesses, and a discussion of particular issues confronting small businesses under the proposed systems. Part III of the pamphlet provides a similar analysis for start-up companies and firms engaged in research activities. The Appendix presents data on C corporations, S corporations, and partnerships by industry and size for 1993.

[1] This document may be cited as follows: Joint Committee on Taxation, *Impact on Small Business of Replacing the Federal Income Tax* (JCS–3–96), April 23, 1996.

I. OVERVIEW

Small businesses

The present-law Federal income tax system presents issues that are of particular concern to small businesses.[2] For example, the differing income tax treatments of various business entities may affect the choice of legal organization. A small business may organize as a sole proprietorship, partnership, limited liability company, or subchapter S corporation, so that business income is taxed directly to the owners of the business as such income is earned. Alternatively, the business may organize as a subchapter C corporation, in which case business income is taxed to the corporation when it is earned and again to the owners when the income is distributed or the business is sold or liquidated.

Income and payroll tax laws may influence the structure of the relationship between an individual service provider and the service recipient. This relationship may be structured so that the worker is treated either as an employee or as an independent contractor. In some instances, employee status is preferable; in other instances, independent contractor status is preferable.

In determining taxable income, present law also provides small businesses and small business investors with special rules regarding the treatment of capital costs and tax accounting methods. These special rules generally ease the administrative burdens of small business as well as lower the tax liabilities of qualifying taxpayers.

Internal Revenue Service ("IRS") data confirm that small businesses organize as sole proprietorships, partnerships, S corporations, and C corporations. In some cases, the Federal income tax rules appear to have an effect on the choice of entity, as exhibited by the growth of the number of S corporations following the Tax Reform Act of 1986. In other cases, the factors that influence the choice of entity by a small business are unclear. One difficulty in analyzing tax return data (or in generally attempting to assess the effect of tax restructuring upon small businesses) is that there is no definitive category of a "small business." In some cases, "smallness" may be determined by the amount of assets; in other cases, it may be determined by the amount of gross receipts or the number of employees.

This pamphlet describes five alternatives to replace the current income tax system. These are (1) a national retail sales tax, (2) a value-added tax, (3) a consumption-based flat tax, (4) a cash flow tax and (5) a "pure" income tax. Other than the "pure" income tax, these alternative tax systems generally are consumption-based, rather than income-based, taxes. The major difference between a consumption-based tax and an income-based tax relates to the treatment of savings. Under an income-based tax, returns to savings (e.g., dividends, interest, and capital gains) generally are subject to tax; under a consumption-based tax, these returns generally

[2] Other aspects of the Federal tax system affect small businesses. For example, the present-law estate and gift tax and the costs of compliance may be of particular concerns to small or closely held businesses. These issues are not addressed in detail in this pamphlet, but will be addressed in future pamphlets to be prepared for additional planned hearings on tax restructuring proposals.

are excluded from the tax base. This exclusion may be provided by taxing consumption directly, excluding investment income from the base, or providing a deduction for increased savings. The current Federal "income" tax contains some features that are consumption-based (e.g., the treatment of qualified retirement plans).

The various alternatives to replace the current income tax system will have different effects upon small businesses. For example, the proposed consumption-based taxes may alleviate present-law choice-of-entity concerns by treating all businesses the same, but may increase the importance of the proper characterization of a worker as an employee or as an independent contractor by providing disparate tax treatment based on the worker's classification. Many of the concerns of small businesses that exist under present law will remain under a "pure" income tax. In fact, a "pure" income tax may result in the repeal of certain beneficial tax provisions currently used by small businesses. However, a consumption tax that treats all businesses the same could also remove these relative benefits.

Start-up companies and firms engaged in research activities

All business, whether currently large or small, begin as "start-up companies." Present law contains provisions that directly affect start-up companies. Specific rules govern the deductibility of start-up and organizational expenditures. In addition, businesses in a start-up phase may generate significant net operating losses, the use of which may be limited if the business undergoes a change of ownership. The treatment of net operating losses under consumption-based tax proposals raise significant issues for start-up companies both on an ongoing and a transitional basis.

Many start-up companies and ongoing companies engage in research activities. Present law generally permits taxpayers to deduct currently (i.e., expense), rather than capitalize, research expenditures. In addition, prior to its expiration, certain taxpayers could claim a research tax credit for certain increases in qualifying research expenditures. The permitted expensing of research expenditures and the research tax credit generally create a subsidy in the Code in favor of research activities relative to other business expenditures. Adoption of a pure income tax or a consumption-based tax would remove the favorable treatment of research expenditures relative to other business expenditures. Compared to present law, this would make investments in research more expensive relative to other business expenditures. Whether treating research expenditures in a neutral manner (relative to other expenditures) would lead to an increase or decrease in research activities depends upon how such expenditures respond to price changes and to changes in the demand for research that might result from other aspects of tax restructuring.

II. SMALL BUSINESSES

A. Present Law and Background

1. Federal income tax rates—summary of certain provisions affecting small business[3]

U. S. individuals (citizens and residents) are taxed at statutory graduated rates ranging from 15 percent (for taxable income of married joint filers or surviving spouses up to $40,100) to 39.6 percent (for taxable income of married joint filers or surviving spouses over $263,750).[4] The Internal Revenue Code of 1986 ("Code") generally defines income inclusively, "from whatever source derived," except for certain items that are specifically excluded. Personal exemptions and deductions reduce taxable income. Net long term capital gains are taxed generally at the same rates as ordinary income except that the maximum rate on such gains is limited to 28 percent.

Corporations are taxed as separate entities, at rates ranging from 15 percent (for taxable income up to $50,000) to 35 percent (for taxable income over $10,000,000). The intermediate rates are 25 percent and 34 percent. The benefit of graduated rates below 34 percent is phased out for corporations with taxable income between $100,000 and $335,000. Thus, a corporation with taxable income between $335,000 and $10,000,000 is effectively subject to a flat rate of 34 percent.[5] There is no separate rate for corporate net long term capital gains.

Alternative minimum taxes apply to both individuals and corporations for "alternative minimum taxable income" that exceeds an exemption amount. The benefit of the exemption amount is phased out in the case of corporations with alternative minimum taxable income of $310,000 or more. This tax, at a lower rate than the maximum regular rate, is imposed on income computed by adding back certain items treated as tax preferences, and without allowing certain credits. The base of items that are added back for this purposes differs somewhat for individuals and corporations. For example, corporations are subject to an adjustment generally based on corporate earnings and profits.

Certain environmental taxes apply only to corporations with adjusted minimum taxable income greater than $2,000,000 (sec. 59A).

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[3] The following summary highlights: (1) the basic rate bracket structure, including certain "phase outs" that affect the tax rates of taxpayers with lower taxable income as compared with those with higher taxable incomes; and (2) certain differences between the tax rates of individuals and corporations. For a more complete description of the present-law tax base and rates, see *Description and Analysis of Proposals to Replace the Federal Income Tax*, Joint Committee on Taxation (JCS–18–95), June 5, 1995, pp. 7–16.

[4] The corresponding amounts for single filers other than surviving spouses and heads of households) are $24,000 and $263,750. The amounts for heads of households are $32,150 and $263,750. These limits, and those cited in the text for married joint filers or surviving spouses, are adjusted annually for inflation. The figures cited are the amounts for 1996.

[5] A similar phaseout applies to corporate income between $15,000,000 and $18,333,333, so that a corporation with income above that amount is effectively subject to a flat rate of 35 percent.

2. Choice of entity and capital structure considerations

In general

Owners of a business may conduct their activities as "sole proprietorships," which do not involve legal entities separate from the owner. However, for a variety of business or other reasons, a separate entity may be used to conduct the business. As one example of a business reason to use a separate entity, under State business laws the use of a corporation or partnership entity can provide limited liability to some or all of the equity investors that would not be available to the owner of a sole proprietorship.

The choice of entity affects the tax treatment of the entity as well as of its investors. As described in detail below, some entities ("pass-through entities") involve one level of tax at the owner level; other entities ("C corporations")[6] involve tax at the entity and the owner level. Present law sets forth criteria applicable in distinguishing among types of entities that receive pass-through tax treatment, and in distinguishing such pass-through entities from C corporations. In general, applicable Treasury regulations provide factors for distinguishing among partnerships, corporations and trusts. In addition, special statutory rules apply to certain types of pass-through entities including S corporations, regulated investment companies, real estate investment trusts, cooperatives, and housing cooperatives.

The tax treatment of the entity and its investors can interact with the choice of capital structure (e.g., whether to raise funds as debt or as equity), because debt and equity investments are treated differently for different types of entities and for different types of investors in those entities.

The differing treatment of debt and equity for tax purposes has led to numerous disputes regarding the proper classification of a particular investment as debt or equity. The form of the instrument is not necessarily controlling. However, taxpayers have considerable latitude in structuring the terms of an instrument so that it will be treated as debt or equity, as desired.[7]

Description of various types of entities and capital structure considerations

Corporations[8]

A corporation that does not qualify for special conduit treatment (a "C corporation") generally is taxed as an entity separate from its shareholders. Thus, the C corporation's income generally is taxed

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[6] The term "C corporation" refers to subchapter C of the Code, which contains rules governing the tax treatment of certain transactions of such corporations and their shareholders..

[7] For further discussion, see, e.g., Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures* (JCS–1–89), January 18, 1989, pp. 35–37.

[8] Data from the Internal Revenue Service from 1993 on C corporations, by taxable income category, indicated that 61 percent of C corporations reported no taxable income, and another 37 percent reported taxable income less than $355,000. Those C corporations reported only 5.3 percent of the total taxable income of C corporations, so that the remaining 94.7 percent of taxable C corporation income came from 2 percent of C corporations (and 79 percent of taxable income came from the 0.1 percent of C corporations subject to tax at a flat rate of 35 percent).

when earned at the corporate level, and is taxed again when distributed as dividends[9] to individual shareholders.

Corporate income that is not distributed to shareholders is subject to current tax at the corporate level only. To the extent that income retained at the corporate level is reflected in an increased share value, the shareholder may be taxed at favorable capital gains rates upon sale or exchange (including certain redemptions) of the stock or upon liquidation of the corporation.[10]

Corporate deductions and credits reduce only corporate income and are not passed through to individual shareholders.

An "accumulated earnings tax" can be imposed on certain earnings in excess of $250,000 ($150,000 for certain service corporations in certain fields) accumulated beyond the reasonable needs of the business (secs. 531–537). A "personal holding company tax" is imposed on certain undistributed personal holding company income, generally where the corporation meets certain closely held stock requirements and more than 60 percent of the adjusted ordinary gross income (as defined) consists of certain passive-type income such as dividends, interest, and similar items (secs. 541–547).

Special rules attempt to limit the use of lower bracket rates by separate corporations that are considered related (sec. 1561) and by certain limited cases of personal service corporations considered to be accumulating income attributable to personal services of the shareholders (sec. 11((b)(2)).

Amounts paid as reasonable compensation to shareholders who are also employees are deductible by the corporation, and thus are taxed only as ordinary income compensation at the individual level. On the other hand, amounts paid as dividends to shareholders are not deductible by the corporation and are taxed as ordinary income to the shareholders. Thus, there is an incentive to pay compensation or other deductible amounts (e.g., rents or royalties) to shareholders who also provide services or property to the corporation sufficient to reduce or eliminate corporate-level tax. To the extent a C corporation is able to establish that amounts paid to shareholder-employees do not exceed reasonable compensation for services provided, corporate-level income and corporate-level tax are reduced and may be eliminated.

In general, interest is deductible by a C corporation but amounts distributed as dividends are not. Subject to business considerations, this creates a tax incentive favoring debt over equity in the capital structure. A common issue in the closely held corporate context is whether instruments denominated as debt and issued to persons who are also equity owners (or to other persons) should be respected as debt or should be recharacterized as additional equity. This determination requires an examination of the economic substance of the instrument.

Both interest and dividends are taxed as ordinary income to individual investors and are tax exempt to tax exempt investors, such

[9] Distributions with respect to stock that exceed corporate earnings and profits are not taxed as dividend income to shareholders but are treated as a tax-free return of capital that reduces the shareholder's basis in the stock. Distributions in excess of corporate earnings and profits that exceed a shareholder's basis in the stock are treated as amounts received in exchange for the stock and accordingly may be taxed to the shareholder at capital gains rates.

[10] If an individual shareholder retains stock until death, the appreciation can pass to the heirs free of income tax (sec. 1014).

as pension plans. However, certain investors may prefer interest to dividends. For example, foreign investors may be exempt on certain interest received from U.S. corporations, but are subject to withholding tax on dividends. Other investors may prefer dividends to interest. For example, a corporate investor generally must include all interest received as ordinary income, but may exclude at least 70 percent of dividends received from another corporation (80 percent if the shareholder owns at least 20 percent of the corporate stock, and 100 percent if the shareholder owns at least 80 percent of the corporate stock).

Because of the tax treatment of capital gains, certain investors may prefer not to receive dividends from a C corporation, but instead may prefer retention of earnings at the corporate level so that the value attributable to those earnings may be realized as capital gains on the sale or disposition of stock. Tax exempt investors, such as pension plans, would be indifferent to this consideration, since both dividends and capital gains are not taxed to them. However, an individual investor in a marginal tax rate bracket higher than the 28 percent maximum rate on capital gains could prefer capital gains. (Any appreciation in the stock that has not been realized at the time of death is exempt from capital gains tax, due to the step-up of basis to fair market value at death). Foreign investors may be exempt from tax on certain capital gains, but subject to withholding tax on dividends.

In some instances, if a C corporation anticipates deductions that may result in a relatively low tax at the corporate level for a significant period, the fact that corporate rates are lower than the top individual rates might encourage use of a C corporation rather than a pass-through entity, particularly if investors anticipate the ability to reduce shareholder level tax on earnings by realizing the value of retained earnings in the form of capital gains on sale of the shares. [11]

A C corporation may also be the entity of choice if a corporation anticipates "going public," since publicly traded partnerships are generally taxed as corporations, and S corporations (discussed below) are not permitted to have more than 35 shareholders and thus are not suitable public offering vehicles.

Partnerships

A partnership is a conduit—i.e., it receives pass-through treatment—for purposes of income tax liability and payments. Conduit treatment for the partnership means that income is taxed at only one level: the partner's level. Each partner takes into income his "distributive share" of the partnership's taxable income and the separately allocable items of income, deduction, and credit (sec. 702(a)). The liability for Federal income tax payment is that of the

[11] The top marginal rate applicable to individuals under present law (39.6 percent) is higher than the top marginal rate applicable to corporations (35 percent). However, the graduation of the corporate and individual rate schedules and the division of corporate income among shareholders may mean that the average and marginal tax rates for the individual shareholders under present law may be lower than the rates applicable to corporations. The relative tax rates applicable to corporations and individuals (and the extent to which business earnings are reinvested in the enterprise) are important considerations in determining whether or not subchapter C status is desirable.

partner, and not of the partnership, even though none of those profits may actually be distributed to the partner (sec. 701).[12]

Conduit treatment for partnerships also means that any partnership losses, deductions, and credits pass through to the partner and can be used to offset other income, thereby reducing the income tax liability of the partner. The amount of losses that a partner may deduct under these provisions for a particular year may not exceed the amount of the adjusted basis of his partnership interest (sec. 704(d)), which, at the inception of the partnership, equals the sum of his capital contribution to the partnership plus his share, if any, of partnership liabilities.

The income tax treatment of a business entity as a C corporation or partnership does not merely depend on the legal form of its organization. Treasury regulations provide that proper treatment of a business entity depends on whether the enterprise "more nearly" resembles a corporation or partnership. In making this determination, the regulations list six factors and provide that an entity is treated as a corporation if it has more corporate than non-corporate characteristics. The six corporate characteristics are: (1) the existence of associates, (2) an objective to carry on business and divide the profits thereon, (3) continuity of life, (4) centralized management, (5) liability limited to the assets of the entity, and (6) free transferability of interests.[13] Various special definitions apply in determining the existence of these characteristics. Because the first two characteristics listed above (associates and profit motive) are common to both partnerships and corporations, an entity is classified as a partnership if it lacks two of the four remaining corporate characteristics. Thus, for example, an entity that lacks continuity of interest and free transferability of interests could be treated as a partnership, even though it may have limited liability and centralized management (see discussion of certain limited liability companies, below).

Partnerships have been used to provide partners a significant amount of flexibility to vary their respective shares of partnership income. Unlike some other types of pass-through entities such as an S corporation (discussed below), partnerships permit a significant amount of flexibility in allocating specific tax consequences to particular partners; for example, depreciation deductions can be al-

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[12] Publicly-traded partnerships (i.e., partnerships whose interests are traded on an established securities market, or are readily tradeable on a secondary market (or the substantial equivalent thereof), generally are treated as corporations (sec. 7704). An exception to this treatment is provided for publicly traded partnerships 90 percent of whose gross income constitutes passive-type income.

Whether a partnership is treated as publicly traded depends on whether its "interests" are publicly traded. Thus, many of the questions that arise in attempting to distinguish between corporate debt and corporate equity arise in similar form in this context. For example, it is unclear under present law to what degree subordination, preference, convertibility, contingency of payments of income or face amount, voting or other rights, transferability, or similar attributes of an interest in a partnership determine whether it represents partnership debt or equity. See *Hambuechen v. Commissioner*, 43 T.C. 90 (1964).

[13] Treas. reg. sec. 301.7701–2(a). The extent to which the Internal Revenue Service ("IRS") will continue to use these tests to determine the tax status of an entity is unclear. On April 3, 1995, the IRS announced that it and the Department of the Treasury are considering simplifying the existing classification regulations to allow taxpayers to elect to treat certain domestic unincorporated business organizations as partnerships or as corporations for Federal tax purposes. This "check-the-box" approach would apply to all domestic organizations with two or more associates and an objective to carry on business and divide the profits therefrom, unless the organization's tax status is determined under another Code provision (e.g., sec. 7704 that applies corporate treatment to certain publicly traded partnerships). IRS Notice 95–14, Bulletin No. 1995–14.

located disproportionally to one partner while taxable income (but not current cash flow) can be allocated disproportionately to another partner. The Code permits such allocations only to the extent they have "substantial economic effect". Within this limitation, however, partners in many instances effectively can use such allocations to transfer tax attributes.

In the closely-held business context (as well as in other cases), partnership interests could be utilized to transfer income from higher-bracket to lower-bracket individuals—for example, within a family. The Code contains special rules respecting or treating certain transfers of partnership interests among family members as gifts where capital is a material income-producing factor to the partnership (sec. 704(e)). Apart from these rules, issues may arise regarding the inclusion of certain family members as partners, that would require examination of the respective contributions of the family members to the partnership in the form of capital or services.

A partner's distributive share of partnership loss for a taxable year is deductible only to the extent of the partner's basis in the partnership interest (sec. 704(d)). A partner's basis for his interest equals the sum of his capital contribution plus his share, if any, of partnership liabilities. A partner's basis in his partnership interest is generally increased by an increase in his share of liabilities and decreased by a decrease in his share of them (among other factors that affect his basis) (sec. 752).[14] Characterization of funds received by a partnership as a liability (rather than, for example, an equity investment in the partnership) thus can increase the basis of all partners in their partnership interests. This is particularly desirable for equity investors who wish to deduct partnership losses currently. While "passive loss" limitations limit the extent to which certain types of limited partner income can be offset by partnership deductions, these limitations do not apply to corporate partners and may not be important to individual partners who have partner level "passive income" from other investments.

Equity investors in a partnership (whether they are limited partners or general partners) generally are treated as receiving their distributive share of partnership income, which generally retains its character in the hands of the partner. Thus, tax exempt and foreign investors, who would not be taxed if they received interest from the partnership, may be taxed on income from equity investment as if they were conducting the underlying U.S. business of the partnership. Such investors thus may prefer to act as lenders, rather than equity investors, in a partnership.

Until recently, there have been few forms of entity other than S corporations (discussed further below) that were treated as partnerships for income tax purposes but had limited liability for the owners under local law. One such vehicle is the limited partnership, through which the liability of certain investors (the limited partners) is limited to the partners' investment in the partnership. Limited partnerships generally are treated as partnerships for income tax purposes because local law generally requires the exist-

[14] By contrast, entity-level debt of other passthrough entities (for example, S corporations) is not included in the investor's basis for his interest in the entity. Similarly, debt of a C corporation is not included in the shareholder's basis for his stock or securities of the corporation.

ence of a general partner whose liability is not limited, and the partnership may lack centralized management, continuity of life, or free transferability of interest.[15] However, a limited partnership may not be an appropriate vehicle for many business enterprises to the extent local law limits the rights of the limited partners.

More recently, however, another form of entity—the limited liability company ("LLC")—has emerged that may provide corporate treatment for local law purposes and partnership treatment for Federal income tax purpose. LLCs are entities organized under State law. Although LLC statutes differ from State to State, common characteristics under most States' laws include limited liability of owners, management vested in owners or managers, lack of free transferability of interests, and often a lack of continuity of life.[16] The first LLC statute was enacted in Wyoming in 1977.[17] In 1980, the Department of the Treasury proposed regulations to Code section 7701 that would have treated an LLC as a corporation for income tax purposes. These regulations were withdrawn in 1982 and, in 1988, the Internal Revenue Service ("IRS") ruled that an LLC organized under the Wyoming statute could be treated as a tax partnership.[18] Currently, almost all States have enacted LLC statutes, and the IRS generally has ruled it will treat such entities as partnerships for tax purposes.[19] Thus, an LLC generally affords local law and income tax treatment similar to that of an S corporation without having to meet the qualification requirements for such treatment under subchapter S.[20] However, an existing C corporation generally may elect subchapter S without incurring a tax on liquidation,[21] and an S corporation may enter into tax-free reorganizations with other corporations.[22] These features generally are not available with respect to LLCs.

S corporations

In many instances, owners of business enterprises may wish to incorporate for nontax reasons (e.g., to obtain limited liability or easier access to capital markets), but would prefer not to have C corporation tax treatment. Noncorporate tax treatment may be pre-

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[15] See, B. Bittker and J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, Chapter 2 (5th. ed. 1987), para. 2.04: "Limited partnerships, whether subject to the original Uniform Limited Partnership Act or the revised version of the Act, come somewhat closer than general partnerships to association status, but not close enough to cross the line, except in extreme cases."

[16] See, Claridy, "The Limited Liability Company: An S Corporation Alternative or Replacement?" 4 *Journal of S Corporation Taxation*, 202 at 203 (1993).

[17] Wyo. Stat. secs. 17–15–101 through 17–15–136 (1977).

[18] Rev. Rul. 88–76, 1988–1 C.B. 260.

[19] See, Frost and Gartland, "Tax Classification of an LLC Raises a Number of Issues," *Journal of Limited Liability Companies*, 3 (1994) for a discussion of the various IRS rulings. See also, Levine and Paul, "Limited Liability Company Statutes: the New Wave," 4 *Journal of S Corporation Taxation*, 226 (1993) for a discussion of how various LLC statutes differ and how such differences may affect the tax treatment of the entity.

[20] Some commentators have suggested that the use of LLCs is not yet as widespread because of the uncertainty of the extent to which a State will recognize the status of an LLC conducting business in that State but organized under the laws of another State. However, the commentators believe that it is only a matter of time until the States begin recognizing each others' LLCs. See, August, "Editor's Comment: The Limited Liability Company—The 'Super Pass–Through Entity'?" 4 *Journal of S Corporation Taxation*, 199 at 200 (1993). Anecdotal information indicates that interstate recognition of LLCs may have already taken place to a great extent.

[21] But see, section 1363(d) (recapture of certain LIFO inventory benefits upon conversion from C corporation status), section 1374 (corporate-level tax on certain built-in gains if recognized within 10 years of conversion), and section 1375 (corporate-level tax on certain passive investment income to the extent of prior C corporation earnings and profits).

[22] Section 1371(a)(1) (rules of subchapter C applicable to S corporations).

ferred because owners may not wish business earnings to be subject to two layers of tax (once when earned and again when distributed), the average or marginal tax rates for the individual shareholders may be lower than that of the corporation, owners may wish to use losses generated by the business to offset income from other sources, and the owners may not wish tax to be imposed under the corporate tax base, which may include items not applicable to individuals (such as the corporate alternative minimum tax).

Subchapter S of the Code allows certain qualified corporations to elect essentially to be relieved from corporate-level taxation and to pass the corporate items of taxable income and loss through to the shareholders of the corporation. Thus, a corporation that elects subchapter S status (an "S corporation") and its shareholders generally are treated more like a partnership and its partners than a C corporation and its shareholders. In order to make an election to be treated as an S corporation, a corporation must meet certain requirements primarily regarding its capital structure and the identity of its shareholders. These requirements are discussed in detail below.

To be eligible to elect S corporation status, a corporation may not have more than 35 shareholders and may not have more than one class of stock. Only individuals (other than nonresident aliens), estates and certain trusts are permitted as shareholders. A corporation may elect S corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than half the stock (sec. 1362). Although there are limitations on the types of shareholders and stock structure an S corporation may have, there is no limit on the size of such a corporation (as there is no limit on the size of a C corporation or partnership).

There is no requirement that an S corporation be engaged in an active business. However, excess passive investment income can cause the automatic termination of S corporation status in some circumstances if an S corporation was previously a C corporation and still has C corporation earnings and profits. In such a case, if the S corporation has passive income amounting to more than 25 percent of its gross receipts for three consecutive years, the corporation loses its S corporation status. This rule is intended to prevent a regular C corporation from electing S status and converting, essentially, into a holding company rather than liquidating and incurring tax at the shareholder level on liquidation proceeds from the period of operation as a C corporation.

S corporations generally are treated for Federal income tax purposes as pass-through entities, not subject to tax at the corporate level (secs. 1363 and 1366). Items of income (including tax-exempt income), loss, deduction and credit of the corporation are taken into account in computing the tax of the shareholders. A shareholder's deduction for corporate losses is limited to the amount of the shareholder's adjusted basis in his stock and in the indebtedness of the corporation to such shareholder. To the extent a loss is not allowed due to this limitation, it generally is carried forward to the next year. The shareholder's basis in his stock and debt is reduced by his share of losses allowed as a deduction and, in the case of stock,

by distributions, and the shareholder's basis in his stock is increased by his share of the corporation's income (sec. 1367).

There are two principal exceptions to the general pass-through treatment of S corporations. Both are applicable only if the corporation was previously a C corporation and are generally intended to prevent avoidance of otherwise applicable C corporation tax consequences. First, an S corporation is subject to tax on excess net passive investment income (but not in excess of its taxable income, subject to certain adjustments), if (for less than three consecutive years[23]) the corporation has subchapter C earnings and profits, and has gross receipts more than 25 percent of which are passive investment income for the year (sec. 1375).

Second, for the first 10 years after a corporation that was previously a regular C corporation elects to be an S corporation, certain net "built-in" capital gains of the corporation attributable to the period in which it was a C corporation are subject to tax at the corporate level (sec. 1374).

In general, a shareholder is not subject to tax on distributions unless they exceed the shareholder's basis in his or her stock of the corporation or the corporation was formerly a C corporation and has remaining earnings and profits (sec. 1368). To the extent of such earnings and profits, corporate distributions are treated like dividends of C corporations and generally are subject to tax as ordinary income in the hands of the shareholders.

Like partnerships, S corporations generally are treated as conduits. Taxable income of an S corporation generally is subject to a shareholder level tax and is taxable regardless of whether it is distributed to shareholders.[24]

However, there are significant differences between S corporations and partnerships. For example, corporate liabilities are not included in a shareholder's basis for his interest in an S corporation. Thus, unlike a limited partner who can take deductions supported by certain partnership nonrecourse indebtedness, S corporation shareholders who wish to obtain similar types of deductions might generally structure borrowings as borrowings to themselves, contributed or re-lent to the S corporation. Also, S corporations generally may have only one class of stock, and thus do not offer the same flexibility as partnerships to allocate income or losses to different investors.[25]

Special rules benefitting small business investors

50-percent exclusion of gains on small business stock

Generally, gain from the sale or exchange of stock held for more than one year is treated as long-term capital gain. Net capital gain (i.e., long-term capital gain less short-term capital loss) of an individual is taxed at the same rates that apply to ordinary income, though subject to a maximum rate of 28 (rather than 39.6) percent.

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[23] If the S corporation continues to have C corporation earnings and profits and has gross receipts more than 25 percent of which are passive investment income in each year for 3 consecutive years, the S corporation election is automatically terminated.

[24] See discussion at footnote11, *supra*.

[25] Anecdotal information indicates that with the emergence of LLCs, fewer new entities are structured as S corporations.

Section 1202 of the Code, added by the Omnibus Budget Reconciliation Act of 1993, provides special rules for certain qualified small business stock issued after August 10, 1993. A noncorporate taxpayer who holds qualified small business stock for more than five years may exclude from income 50 percent of any gain on the sale or exchange of the stock. The amount of gain eligible for the 50 percent exclusion is limited to the greater of (1) 10 times the taxpayer's basis in the stock or (2) $10 million gain from stock in that corporation.

The stock must be acquired by the taxpayer at the original issuance (directly or through an underwriter) in exchange for money or other property, or as compensation for services provided to the issuing corporation (other than services performed as an underwriter or the stock). Special anti-evasion rules apply for this purpose.

As of the date of issuance of the stock, the excess of (1) the amount of cash and the aggregate adjusted bases of other property held by the corporation over (2) the aggregate amount of indebtedness of the corporation that does not have an original maturity of more than one year (such as short-term payables) cannot exceed $50 million. For this purpose, amounts received in the issuance are taken into account.

During substantially all of the taxpayer's holding period for the stock, at least 80 percent (by value) of the corporation's gross assets (including intangible assets) must be used by the corporation in the active conduct of a qualified trade or business (including certain start up activities). A qualified trade or business is any trade or business other than one involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees. the term also excludes any banking, insurance, leasing, financing, investing, or similar business, any farming business (including the business of raising or harvesting trees), any business involving the production or extraction of products of a character for which percentage depletion is allowable, or any business of operating a hotel, motel, restaurant, or similar business.

A corporation that is a specialized small business investment company ("SSBIC") is treated as meeting the active business test. An SSBIC is defined as any operation (other than certain nonqualified corporations) that is licensed by the Small Business Administration under section 301(d) of the Small Business Act of 1958, as in effect on May 13, 1993.

Rollover of gains into SSBICS

In general, gain or loss is recognized on any sale, exchange, or other disposition of property. The Code contains certain provisions under which taxpayers may elect not to recognize gain realized on certain "like-kind" exchanges (sec. 1031) or for certain involuntary conversions (sec. 1033). However, no such nonrecognition provision generally applies to gain on stocks or securities.

Section 1044, enacted in 1993, permits any corporation or individual to elect to roll over without payment of tax any capital gain

realized upon the sale of publicly traded securities on or after August 10, 1993, where the corporation or individual uses the proceeds from the sale to purchase common stock or a partnership interest in a specialized small business investment corporation ("SSBIC") within 60 days of the sale of the securities. To the extent the proceeds from the sale of the publicly-traded securities exceed the cost of the SSBIC common stock or partnership interest, gain is recognized currently. The taxpayer's basis in the SSBIC common stock or partnership interest is reduced by the amount of any gain not recognized on the sale of the securities.

The amount of gain the an individual may elect to roll over for a taxable year is limited to the lesser of (1) $50,000 or (2) $500,000 reduced by the gain previously excluded under the provision. For corporations, these limits are $250,000 and $1,000,000.

Losses of small business investment companies ("SBICS") treated as ordinary losses

Generally, losses on stock investments are treated as capital losses. Such losses may offset capital gains. Corporations are not permitted to offset any amount of ordinary income with capital losses.

In the case of a small business investment company operating under the Small Business Investment Act of 1958, a loss on stock received pursuant to the conversion privilege of convertible debentures acquired pursuant to section 304 of that Act, that would otherwise be treated as a capital loss, is treated as an ordinary loss.

Losses on small business corporation stock treated as ordinary losses

Generally, losses on stock investments are capital losses. Such losses may offset capital gains. However, an individual may not offset more than $3,000 of ordinary income in any year with capital losses.

A special provision permits an individual to treat up to $50,000 ($100,000 on a joint return) of losses on certain small business stock as ordinary losses. Qualifying stock is stock issued by a qualifying domestic small business corporation for money or other property (other than stock or securities). During the period of its five most recent taxable years (or shorter period the corporation's existence) ending before the date of the loss, the corporation must have derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stocks or securities.

A corporation is a small business corporation for this purpose only if the aggregate amount of money or other property received by the corporation for stock, as a contribution to capital, and as paid-in surplus, does not exceed $1,000,000 as of the time of issuance of the stock (including amounts received for such stock).

Tax-exempt financing[26]

In General.—The Code exempts interest on certain debt obligations of States, territories, and possessions of the United States from the regular individual and corporate income taxes. Interest on debt of local governments generally receives identical treatment to that provided for State debt. This State and local government bond interest exemption applies both to bonds issued to finance activities conducted and paid for by these governments and to bonds issued for and re-paid by certain private entities if the private activity being financed is specified in the Code. The specified private activities generally relate to transportation, privately provided municipal services, economic development, and certain social programs (e.g., mortgage revenue bonds). Issuance of most tax-exempt private activity bonds, including those described below, is subject to annual, aggregate per–State limits of $50 per resident ($150 million if greater).

Qualified small-issue bonds.—States and local governments may issue qualified small-issue bonds to provide tax-exempt financing for capital expenditures of certain manufacturing businesses and first-time farmers. In general, no more than $1 million of qualified small-issue bond financing may be outstanding at any time for property of a business located in the same municipality or county. This $1 million limit may be increased to $10 million if other capital expenditures of the business in the same municipality or county are counted. Aggregate outstanding borrowing under this program is limited to $40 million per borrower regardless of where the property is located. No more than $250,000 per borrower ($62,500 for used property) may be used to finance depreciable farm property.

Bonds for empowerment zone and enterprise community businesses.—Tax-exempt bonds may be issued to finance capital expenditures of businesses located in Federal empowerment zones and enterprise communities. The amount of these bonds is limited to $3 million per business in any one zone; businesses are further subject to a $20 million aggregate limit on such bonds for property in all zones and communities. Businesses receiving this tax-exempt financing must continuously qualify as a "zone" or "community" business throughout the term of the tax-exempt financing provided.

3. Expensing of capital costs

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through allowances for depreciation or amortization. Tangible property generally is depreciated under a modified Accelerated Cost Recovery System ("MACRS") of section 168, which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to expense and deduct up

[26] A more comprehensive discussion of tax-exempt financing will be presented in a subsequent pamphlet, to be issued in connection with the scheduled May 1, 1996 hearing before the House Committee on Ways and Means regarding the impact on State and local governments and tax-exempt entities of replacing the Federal income tax.

to $17,500 of the cost of qualifying property placed in service for the taxable year (sec. 179).[27] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $17,500 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). In the case of a partnership (or S corporation), the $17,500, $200,000, and taxable income limitations are applied at the partnership (or corporate) and partner (or shareholder) levels.

4. Accounting methods

In general

A taxpayer must compute its taxable income under a method of accounting on the basis of which the taxpayer regularly keeps its books so long as, in the opinion of the Secretary of the Treasury, such method clearly reflects the taxpayer's income (sec. 446 of the Code). Among the permissible methods of accounting are the cash receipts and disbursement method ("cash method"), an accrual method, any other method permitted or required under the Code, or any hybrid method allowed under regulations. A taxpayer may change its method of accounting with the consent of the Secretary.

Special statutory rules allow small businesses to use accounting methods that are unavailable to larger taxpayers. Many of these rules are designed to alleviate the tax accounting burdens of small businesses, while other rules are designed to provide a tax incentive for small businesses. Some of these special rules are described below.

Cash and accrual methods

Under the cash method of accounting, income is recognized and deductions are allowed when the taxpayer receives or remits cash or cash equivalents. The cash method is administratively easy, provides the taxpayer flexibility in the timing of its income and deductions, and is the method generally used by most individual taxpayers.

Under an accrual method of accounting, income generally is recognized in the year in which all the events have occurred that establish the taxpayer's right to receive the income and the amount of the income can be determined with reasonable accuracy. A deduction is allowed for an expense in the year in which all events have occurred that establish the liability of the taxpayer for the expense, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect

[27] The amount permitted to be expensed under section 179 is increased by up to an additional $20,000 for certain property placed in service by a business located in an empowerment zone (sec. 1397A).

to the item of expense. Accrual methods of accounting generally result in a more accurate measure of economic income than does the cash method, conform to generally accepted accounting principles, and are used by most businesses for financial accounting purposes.

In general, a taxpayer must use an accrual method of accounting for Federal income tax purposes if the taxpayer's average annual gross receipts for all prior taxable years exceed $5 million (section 448 as added by the Tax Reform Act of 1986 ("1986 Act")). Individuals, partnerships (other than partnerships having a C corporation as a partner), S corporations, and "qualified personal service corporations"[28] are exempt from the required use of an accrual method.

Special rules are provided for farm businesses. A corporation (or a partnership with a corporate partner) engaged in the trade or business of farming must use an accrual method of accounting for such activities unless such corporation (or partnership), for each prior taxable year beginning after December 31, 1975, did not have gross receipts exceeding $1 million. A provision of the Revenue Act of 1987 requires a family corporation (or a partnership with a family corporation as a partner) to use an accrual method of accounting for its farming business unless, for each prior taxable year beginning after December 31, 1985, such corporation (and any predecessor corporation) did not have gross receipts exceeding $25 million. A family corporation is one where at 50 percent or more of the stock of the corporation is held by one family (or in some limited cases, two or three families.)

Thus, many small businesses are exempt from the statutorily mandated use of an accrual method of accounting either because the small business is not organized as a C corporation, has average annual gross receipts of less than the threshold amount, or is a qualified personal service corporation. However, in order for a small business to use the cash method of accounting for Federal income tax purposes, the method must, in the opinion of the Secretary of the Treasury, clearly reflect the taxpayer's income. For example, Treasury regulations require the use of an accrual method of accounting where purchases and sales of merchandise by a business are material income-producing factors. Taxpayers often enter into disputes with the IRS regarding whether an item is "material" or whether income is "clearly reflected."

Uniform capitalization of inventory costs

A taxpayer that sells goods in the active conduct of its trade or business generally must maintain inventory records in order to determine the cost of goods it sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to purchases made during the

[28] A qualified personal service corporation is a corporation meeting a function test and an ownership test. The function test is met if substantially all the activities of the corporation involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. The ownership test is met if substantially all of the value of the outstanding stock of the corporation is owned by present or retired employees, the estates of such persons, by any person who acquired its ownership interest as the result of the death of such a person within the previous 24 months, or by a holding company the stock of which is owned by employees of the corporation, or employees of the affiliate of the corporation, that is engaged in the same field of service.

period and subtracting from that sum the taxpayer's inventory at the end of the period.

In general, the uniform cost capitalization rules (as added by the 1986 Act) require taxpayers that are engaged in the production of real or tangible personal property or in the purchase and holding of property for resale to capitalize or include in inventory the direct costs of the property and the indirect costs that are allocable to the property. Direct costs generally are the costs directly associated with the production of a good; i.e., the materials and labor applied in the production of the cost. Indirect costs are costs associated with functions removed from the direct production of the good; e.g., overhead and administrative costs. In determining whether indirect costs are allocable to production or resale activities, taxpayers are allowed to use various methods so long as the method employed reasonably allocates indirect costs to production and resale activities.

However, the uniform capitalization rules do not apply to property acquired by a taxpayer during the taxable year for resale if the average annual gross receipts of the taxpayer for the preceding three taxable years did not exceed $10,000,000.

Simplified dollar-value LIFO method for small businesses

Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows. Among these conventions is the "last-in-first-out" ("LIFO") method which assumes that the items in ending inventory are those earliest acquired by the taxpayer. One method of applying the LIFO method to inventories is the dollar-value method. Under the dollar-value LIFO method, the taxpayer accounts for its inventories on the basis of a pool of dollars rather than on an item-by-item basis. Each pool of dollars includes the value of a number of different types of inventory items. Generally, for wholesalers, retailers, jobbers and distributors, items of inventory are pooled by major lines, types or classes of goods. In the case of manufacturers, all inventory items which represent a natural business unit may be combined into a single pool. Similarly, taxpayers may assign inventory items to one of a number of pools determined by the similarity of the different types of items to each other.

The dollar-value method measures each pool of dollars in terms of the equivalent dollar value of the inventories at the time the portion of the pool of dollars was first added to the inventory account. In order to measure the pool of dollars in terms of equivalent dollar values, the use of the dollar-value LIFO method requires the development of an index which will discount present dollar values back to the equivalent dollar values of the first year the taxpayers uses the LIFO method (called the "base year"). This is normally done by comparing the dollar amount of inventory items measured in present year prices against the dollar amount of the same inventory items in base year prices (the "double-extension" method). If the permission of the Secretary of the Treasury is obtained, however, the index may be developed by comparing the dollar amount of inventory items measured in present year prices against the dollar amount of the same inventory items measured in the immediate prior year's prices. This computation yields an

annual index component that, when applied to all prior annual index components, creates a cumulative index which discounts present dollar values back to the equivalent dollar values of the base year (the "link-chain" method).

Instead of using actual inventory prices, a taxpayer may use tables of price changes published by the Bureau of Labor Statistics as part of the "Producers Price Index" and "Consumer Price Index" publications to construct the index necessary to determine equivalent dollar values. Use of these tables requires an index specific to the taxpayer to be constructed by taking a weighted average of price changes for specific categories of inventory. Taxpayers generally are limited to an index equal to 80 percent of the constructed index.

Section 474, as added by the 1986 Act, provides an election to certain small businesses to use a simplified dollar-value LIFO method in accounting for their inventories. The simplified dollar-value LIFO method requires inventories to be grouped into pools in accordance with the major categories of the "Producer Prices Indexes" or the "CPI Detailed Report." The change in inventory costs for the pool for the taxable year is determined by the change in the published index for the general category to which the pool relates. The computation of the ending LIFO value of the pool is then made using the dollar-value LIFO method. The indices necessary to compute the equivalent dollar values of prior years are to be developed using the link-chain method.

The computation of inventory values using the simplified dollar-value LIFO method generally follows the rules applicable to other taxpayers for the computation of inventories using the dollar-value LIFO. The simplified dollar-value LIFO method differs from these current rules, however, with regard to the manner in which inventory items are to be pooled, the use of published indices to determine an annual index component for each pool, and the technique to be used in computing the cumulative index for a pool for any given year. Moreover, small businesses may use 100 percent (rather than 80 percent) of the computed indices. For this purpose, an eligible small business is one with average annual gross receipts for the preceding three taxable years of $5,000,000 or less.

Installment sales

The installment method of accounting may be used in defer income that is recognized for any taxable year from nondealer dispositions of property. However, an interest charge is imposed on the tax that is deferred under the installment method. The interest charge does not apply to the extent attributable to the amount by which the deferred payments arising from dispositions of all such property during a taxable year exceed $5 million. In determining the $5 million amount, only transactions with sales prices in excess of $150,000 are taken into account. Thus, an owner of a small business may sell his or her business on the installment method and defer tax without incurring the interest charge applicable to larger transactions.

Long-term contracts

Taxpayers engaged in the production of property under a long-term contract generally must compute income from the contract under the percentage of completion method (Sec. 460, as added by the 1986 Act). Under the percentage of completion method, a taxpayer must include in gross income for any taxable year an amount that is based on the product of (1) the gross contract price and (2) the percentage of the contract completed as of the end of the year. The percentage of the contract completed as of the end of the year is determined by comparing costs incurred with respect to the contract as of the end of the year with estimated total contract costs.

Because the percentage of completion method relies upon estimated, rather than actual, contract price and costs to determine gross income for any taxable year, a "look-back method" is applied in the year a contract is completed in order to compensate the taxpayer (or the IRS) for the acceleration (or deferral) of taxes paid over the contract term. The first step of the look-back method is to reapply the percentage of completion method using actual contract price and costs rather than estimated contract price and costs. The second step generally requires the taxpayer to recompute its tax liability for each year of the contract using gross income as reallocated under the look-back method. If there is any difference between the recomputed tax liability and the tax liability as previously determined for a year, such difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily. The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments. The look-back method must be reapplied for any item of income or cost that is properly taken into account after the completion of the contract.

The look-back method does not apply to any contract that is completed within two taxable years of the contract commencement date and if the gross contract price does not exceed the lesser of (1) $1 million or (2) one percent of the average gross receipts of the taxpayer for the preceding three taxable years. Thus, the contracts of many small businesses are subject to the percentage-of-completion method but not subject to the look-back method.

Bad debt reserves of small banks

Generally, a taxpayer engaged in a trade or business may deduct the amount of any debt that becomes wholly or partially worthless during the year (the "specific charge-off" method). However, a small commercial bank (i.e., one with adjusted bases of assets of $500 million or less) may use the experience method or the specific charge-off method for purposes of computing its deduction for bad debts. Under the experience method, a thrift institution generally is allowed a deduction for an addition to its bad debt reserve equal to the greater of: (1) an amount based on its actual average experience for losses in the current and five preceding taxable years, or (2) an amount necessary to restore the reserve to its balance as of the close of the base year. For taxable years beginning after 1987, the base year is the last taxable year beginning before 1988. The

use of a reserve method for bad debts allows a small bank to deduct loan losses before the loans become wholly or partially worthless. Pursuant to a provision in the 1986 Act, a large commercial bank must use the specific charge-off method.

5. Worker classification

Introduction

Among the ways in which an individual may operate a small business is as an independent contractor or a sole proprietor. For Federal tax purposes, whether or not someone is operating a business in such cases depends on whether the individual is classified as an employee of the service recipient or as self employed.

Significant Federal tax consequences result from the classification of a worker as an employee or self employed. These differences relate to withholding and employment tax requirements, as well as the ability to exclude certain types of compensation from income or take tax deductions for certain expenses. Some of these consequences favor employee status, while others favor self-employment status.

Under present law, the determination of whether a worker is an employee or self employed is generally made under a facts and circumstances test that seeks to determine whether the service provider is subject to the control of the service recipient, not only as to the nature of the work performed, but the circumstances under which it is performed. Under a special safe harbor rule (sec. 530 of the Revenue Act of 1978), a service recipient may treat a worker as self employed for employment tax (but not income tax) purposes even though the worker is in fact an employee if the service recipient has a reasonable basis for treating the worker as self employed and certain other requirements are met.

Classification of workers

In general

In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common-law test. Under this test, an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished. Whether the requisite control exists is determined based on all the relevant facts and circumstances.[29]

The Internal Revenue Service ("IRS") has developed a list of 20 factors that may be examined in determining whether an employee-employer relationship exists. The 20 factors were developed by the IRS based on an examination of cases and rulings considering whether a worker is an employee. The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed. The 20 factors are designed as guides; special scrutiny may be required in applying the

[29] Treas. Reg. sec. 31.3401(c)–(1)(b). There are also some persons who are treated by statute as either employees or independent contractors. For example, full-time life insurance salesmen and certain travelling salesmen are treated as employees for purposes of employment taxes (sec. 3121(d)). Real estate agents and direct sellers are not treated as employees (sec. 3508).

factors to assure that formalistic aspects of an arrangement designed to achieve a particular status do not obscure the substance of the arrangement.[30]

Section 530 of the Revenue Act of 1978

With increased enforcement of the employment tax laws beginning in the late 1960s, controversies developed between the IRS and taxpayers as to whether businesses had correctly classified certain workers as self employed rather than as employees. In some instances when the IRS prevailed in reclassifying workers as employees under the common-law test, the employing business became liable for substantial portions of its employees' employment and income tax liabilities (that the employer had failed to withhold and pay over), although the employees might have fully paid their liabilities for self-employment and income taxes.

In response to this problem, the Congress enacted section 530 of the Revenue Act of 1978 (P.L. 95–600) ("section 530"). That provision generally allows a taxpayer to treat a worker as not being an employee for employment tax purposes (but not income tax purposes), regardless of the individual's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment. Under section 530, a reasonable basis is considered to exist if the taxpayer reasonably relied on (1) past IRS audit practice with respect to the taxpayer, (2) published rulings or judicial precedent, or (3) long-standing recognized practice in the industry of which the taxpayer is a member. Under the prior-audit rule, reasonable reliance is generally found to exist if the IRS failed to raise an employment tax issue on audit, even though the audit was not related to employment tax matters.

The relief under section 530 is available with respect to an individual only if certain additional requirements are satisfied. One of these requirements is that the taxpayer (or a predecessor) must not have treated any individual holding a substantially similar position as an employee for purposes of employment taxes for any period beginning after 1977.

Under section 1706 of the Tax Reform Act of 1986, section 530 does not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled

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[30] Rev. Rul. 87–41, 1987–1 C.B. 296. The factors are as follows: (1) whether the worker is required to comply with instructions about when, where, and how to perform the work; (2) whether the service recipient trains the worker; (3) the extent to which the worker's services are integrated into the business operations of the service recipient; (4) whether the services must be rendered personally; (5) whether the service recipient supervises the worker; (6) whether there is a continuing relationship between the worker and the service recipient; (7) whether the service recipient sets the hours of work of the worker; (8) whether the worker is required to devote substantially full time to the business of the service recipient; (9) whether the work is done on the premises of the service recipient; (10) whether the worker must perform services in the order set by the service recipient; (11) whether reports by the worker to the service recipient are required; (12) whether payment is by the hour, week, or month; (13) whether the service recipient pays the worker's business and/or traveling expenses; (14) whether the worker is required to furnish his or her own tools; (15) whether the worker invests in facilities used to perform the work; (16) whether the worker can realize a profit or loss as a result of the performance of the services; (17) whether the worker performs services for more than one service recipient; (18) whether the worker makes his or her services available to the general public; (19) whether the service recipient has the right to discharge the worker; and (20) whether the worker has the right to terminate the relationship without incurring liability.

worker engaged in a similar line of work. Thus, the determination of whether such individuals are employees or self employed is made in accordance with the common-law test.

Section 530 also prohibits the issuance of Treasury regulations and revenue rulings on common-law employment status. Taxpayers may, however, obtain private letter rulings from the IRS regarding the status of workers as employees or independent contractors.

Consequences of worker classification

Income tax withholding

The Code requires that employers making payments of wages to employees withhold Federal income taxes from those wage payments in accordance with tables or computational procedures prescribed by the IRS. Each employee must file with his or her employer a Withholding Allowance Certificate (Form W–4) on which the employee claims a specific number of withholding allowances based on family size, employment status, itemized deductions, and other matters. The employer then utilizes tables issued by the IRS to compute the correct amount of Federal income tax withholding. This computation is based on the number of withholding allowances claimed, the taxpayer's wages, and the frequency of payroll payments. The amount of wages paid and the amount of income taxes withheld must be reported to the IRS and to the employee on Form W–2.

No income tax withholding is required on payments made to self-employed individuals.[31] Such individuals are required to make quarterly estimated tax payments.

Employment taxes

If an employer-employee relationship exists, the service recipient is subject to social security taxes under the Federal Insurance Contributions Act ("FICA") and unemployment taxes under the Federal Unemployment Tax Act ("FUTA"), and is required to withhold and pay over FICA and FUTA taxes imposed on the worker. On the other hand, if there is no employer-employee relationship, the service recipient is not subject to employment taxes; the worker pays self-employment tax under the Self-employment Contributions Act ("SECA") in lieu of FICA tax. Self-employed individuals are not subject to FUTA, but also generally are not entitled to related unemployment benefits.

Prior to 1990, the employment tax structure significantly favored independent contractors. Until 1983, the combined FICA tax rate on the employer and employee was significantly higher than the SECA tax rate. The Social Security Amendments Act of 1983 equalized the tax rates, but provided a credit for a portion of SECA taxes for years 1984 through 1989. For years after 1989, the tax rates are the same, and there is no SECA tax credit. A self-employed person is entitled to an income tax deduction for a portion of SECA taxes.

Some differences still exist between FICA and SECA taxes, primarily because the base for calculating the taxes differs.

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[31] Payments to independent contractors may be subject to backup withholding under certain circumstances (sec. 3406).

Pensions and employee benefits

If an individual is not an employee for Federal income tax purposes, the individual is entitled to establish his or her own retirement plan ("Keogh plan") to which the individual can make annual deductible contributions of $30,000 or more. If an individual is an employee for Federal income tax purposes, then employer contributions to a retirement plan are excludable from income. The limits on the benefits that can be provided under a plan maintained by a self-employed individual are generally the same as those that apply to employees. However, individuals may have greater flexibility if they maintain their own qualified plan than if they were under an employer's plan, and may make greater contributions than an employer would make under an employer-sponsored plan. In some circumstances, an employer might wish to treat a worker as self employed in order to avoid providing the worker with retirement and other employee benefits.

Workers who are classified as employees are entitled to exclude from gross income certain employee benefits that cannot be excluded by workers classified as self employed. For example, benefits such as employer-provided health care, dependent care, and group-term life insurance are excluded from income (and wages for FICA tax purposes) of employees. Self-employed individuals are entitled to deduct 30 percent of the cost of their health insurance.

Miscellaneous business expenses

Self-employed individuals receive favorable tax treatment with respect to business expenses. For example, business expenses (such as meals and entertainment, a home office, and transportation) are deductible by self-employed individuals without regard to the amount of the expenses or whether they itemize deductions. On the other hand, an employee generally cannot deduct business expenses without itemizing deductions. For employees who itemize, miscellaneous business deductions for unreimbursed employee business expenses are generally subject to the two-percent-of-adjusted gross income floor on itemized deductions.[32]

Non-Federal tax consequences

There also may be non-Federal tax consequences of worker classification. For example, State income tax laws may follow the Federal classification rules. Also, coverage under Federal and State workers' compensation plans, wage and hour laws, and similar worker-related programs may depend on the classification of a worker as an employee.

Reporting requirements and penalties

Reporting requirements

Employers must report to the IRS the amount of all wages paid to employees on Form W–2. A service recipient engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must

[32] Business expenses that are reimbursed by the employer are generally excludable from an employee's gross income (and wages for employment tax purposes) if the expenses would be deductible (without regard to the two-percent floor) if paid directly by the employee.

file with the IRS an information return (Form 1099) reporting such payments (and the name, address, and taxpayer identification number of the payee) if the remuneration paid to the person during the calendar year is $600 or more. Also, the service recipient must furnish to the person receiving such payments a statement setting forth the name, address, and taxpayer identification number of the service recipient, and the aggregate amount of payments made to the payee during the year.

Penalties

Present law contains a number of civil and criminal penalties designed to further compliance with the Federal income tax rules.

Any person that fails to file a correct information return (such as Forms W–2 or 1099) with the IRS on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. Special, lower maximum levels for this penalty apply to small businesses. Any person that fails to furnish a correct payee statement to a taxpayer (such as a copy of a W–2 or a 1099) on or before the prescribed due date or to comply with other specified information reporting requirements is subject to a penalty of $50 per statement, with a maximum penalty of $100,000 per calendar year.

The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation overstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. The fraud penalty, which is imposed at a rate of 75 percent, applies to the portion of any underpayment that is attributable to fraud.

A penalty for aiding and abetting the understatement of tax liability applies in certain cases in which an individual aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return.

A penalty applies for failure to make timely deposits of tax. The amount of the penalty varies with the length of time within which the taxpayer corrects the failure.

In general, penalties may be abated if it is shown that there was reasonable cause for the failure.

If an employer treats services performed by an employee as if performed by a nonemployee and fails to withhold income or social security taxes as required by the wage withholding provisions of the income tax and social security tax laws, the employer's liability for those amounts is determined as a fraction of the employee's wages subject to income tax withholding or a fraction of the social security taxes required to be withheld. The Code applies a lower fraction if the employer has complied with information reporting rules consistent with the treatment of the employee as a nonemployee.

6. Dual-use property

In general

One of the tax questions relating to small business is the proper tax treatment of property, such as a home, a car, or computer equipment, that is used by the small business owner or operator partly for business purposes and partly for personal purposes. Present law contains a number of special rules designed to address the treatment of such dual-use property.

Listed property

A taxpayer generally may deduct ordinary and necessary expenses paid or incurred in carrying out a trade or business or for the production or collection of income. A deduction generally is not permitted for capital expenses. However, depreciation deductions are allowed for certain property used in a trade or business. In general, tangible property is depreciated under the Modified Accelerated Cost Recovery System. In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $17,500 of the costs of qualifying property placed in service during the taxable year.

Depreciation deductions and expensing are available only with respect to the portion of the cost of an asset that is attributable to business use.[33] In addition, special rules apply in the case of automobiles and certain other types of property (called "listed property") used primarily for personal or investment use rather than in the conduct of a trade or business. Under these special rules, the expensing election is not available and depreciation must be computed under the straight-line method using a specified life longer than the normally applicable life if use of listed property for personal purposes or the production of income (as opposed to trade or business use) constitutes 50 percent or more of the property's use.

Listed property is (1) passenger automobiles, (2) any other property used as a means of transportation, (3) any property of a type generally used for purposes of entertainment, recreation, or amusement, (4) computer or peripheral equipment (other than equipment used exclusively at a regular business establishment and owned or leased by the person operating such establishment), (5) any cellular telephone, and (6) any other property specified by the Treasury.

Restrictions also apply to the deduction of expenses with respect to listed property used by an employee. Employee use of listed property is not treated as use in a trade or business in determining the amount of depreciation deductions allowable to the employee unless such use is for the convenience of the employer and required as a condition of employment.

Home office expenses

A taxpayer's business use of his or her home may give rise to a deduction for the business portion of expenses related to operating the home (e.g., a portion of rent or depreciation and repairs). However, business deductions generally are allowed only with respect to a portion of a home that is used exclusively and regularly in one

[33] Even when depreciation deductions or expensing are allowed, they are limited in amount.

of the following ways: (1) as the principal place of business for a trade or business; (2) as a place of business used to meet with patients, clients, or customers in the normal course of the taxpayer's trade or business; or (3) in connection with the taxpayer's trade or business, if the portion so used constitutes a separate structure not attached to the dwelling unit. In the case of an employee, the business use of the home must be for the convenience of the employer.[34] These rules apply to houses, apartments, condominiums, mobile homes, boats, and other similar property used as the taxpayer's home.

Prior to 1976, expenses attributable to the business use of a residence were deductible whenever they were "appropriate and helpful" to the taxpayer's business. In 1976, the present-law provision was enacted, in order to provide a narrower scope for the home office deduction, but it did not define the term "principal place of business." In *Commissioner v. Soliman*, 113 S.Ct. 701 (1993), the Supreme Court reversed lower court rulings and upheld an IRS interpretation that disallowed a home office deduction for a self-employed anesthesiologist who practiced at several hospitals but was not provided office space at the hospitals. Although the anesthesiologist used a room in his home exclusively to perform administrative and management activities for his profession (i.e., he spent two or three hours a day in his home office on bookkeeping, correspondence, reading medical journals, and communicating with surgeons, patients, and insurance companies), the Supreme Court upheld the IRS position that the "principal place of business" for the taxpayer was not the home office, because the taxpayer performed the "essence of the professional service" at the hospitals.[35]

Present law contains a special rule that allows a home office deduction for business expenses related to a space within a home that is used on a regular (even if not exclusive) basis as a storage unit for the inventory of the taxpayer's trade or business of selling products at retail or wholesale, but only if the home is the sole fixed location of such trade or business.

Home office deductions may not be claimed if they create (or increase) a net loss from a business activity, although such deductions may be carried over to subsequent taxable years.

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[34] If an employer provides access to suitable space on the employer's premises for the conduct by an employee of particular duties, then, if the employee opts to conduct such duties at home as a matter of personal preference, the employee's use of the home office is not "for the convenience of the employer." See, e.g., *W. Michael Mathes*, (1990) T.C. Memo 1990–483.

[35] In response to the Supreme Court's decision in *Soliman*, the IRS revised its *Publication 587, Business Use of Your Home*, to more closely follow the comparative analysis used in *Soliman* by focusing on the following two primary factors in determining whether a home office is a taxpayer's principal place of business: (1) the relative importance of the activities performed at each business location; and (2) the amount of time spent at each location.

B. Descriptions of Restructuring Alternatives

The press release by the House Committee on Ways and Means announcing this set of tax restructuring hearings asked all witnesses to comment on the impact of certain basic tax reform proposals. These basic alternatives to replace the current tax system are: (1) a national retail sales tax; (2) a value-added tax; (3) a flat "consumption" tax; (4) a cash flow tax; and (5) a "pure" income tax.

This section provides brief descriptions of these alternative tax systems. In some cases, the descriptions include summaries of introduced legislation; in other cases, the descriptions are based upon theoretical models of the tax systems. These descriptions provide a summary description of the alternative systems and are not intended to provide detailed analyses of different aspects of the proposed systems. Such analyses will be provided in pamphlets to be prepared for upcoming hearings.[36]

Other than the "pure" income tax, the alternative tax systems discussed in this section are consumption-based, rather than income-based, taxes. The major difference between a consumption-based tax and an income-based tax generally involves the treatment of savings. Under an income-based tax, returns to savings (e.g., dividends, interest, and capital gains) generally are subject to tax. Under a consumption-based tax, returns to savings generally are excluded from the tax base. Such exclusion may be achieved by taxing consumption directly, excluding investment income from the tax base, or providing a deduction for increased savings.[37]

1. National retail sales tax

Overview

As the name implies, a retail sales tax is a tax imposed on the retail sales price (i.e., sales to consumers, but not sales of inputs to businesses) of taxable goods or services.

The Federal Government currently imposes excise taxes on various products and services.[38] However, these taxes generally apply to a narrowly defined class of goods and services, and generally are not imposed at the retail level. Rather, the present-law Federal excise taxes generally are imposed upon manufacturers (as in the case of the alcohol and tobacco excise taxes) or some other intermediate (pre-retail) stage of the distribution of a product (as in the case of the highway motor fuels tax), or are imposed upon both the consumers and business users of a good or service (as in the case of the communications services tax ("telephone tax") or the currently expired air passenger ticket tax).

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[36] Additional analysis can be found in Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS–18–95), June 5, 1995, and Martin A. Sullivan, *Flat Taxes and Consumption Taxes: A Guide to the Debate*, American Institute of Certified Public Accountants, December 1995.

[37] For a further discussion of the distinctions between consumption-based taxes and income-based taxes and the equivalence among different types of consumption taxes, see Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* and the citations contained therein.

[38] See, Joint Committee on Taxation, *Schedule of Present Federal Excise Taxes (As of January 1, 1994)* (JCS–5–94), June 28, 1994, for a description the various Federal excise taxes.

Most States and many local governments impose general sales taxes within their jurisdictions,[39] and all States impose some form of excise-type tax on specified goods or services. Although the typical State sales tax is familiar to most consumers and appears simple on its face, several issues may arise in the application of such a tax. First, State sales taxes generally are designed to apply to most tangible personal property and selected services purchased by consumers.[40] Certain sales to persons other than consumers (i.e., businesses) may be exempted from the tax in a variety of ways. Exemptions may be provided for goods acquired as "sales for resale," or for articles for use in manufacture, fabrication, or the processing of personal property for resale, if the article becomes incorporated in such property. Thus, persons who are not consumers may be subject to the sales tax in certain instances. For example, a furniture maker may be exempt from tax on lumber acquired to manufacture chairs, but would not be exempt from tax on a truck purchased to deliver the chairs to customers. Controversies often arise as to whether or not an article or a service (such as packaging or utility services) are incorporated into a good.[41] Most States also provide exemptions for acquisitions by the State and its political subdivisions, and charitable, religious, and educational organizations.[42] In order to address the regressivity of sales taxes, most States exempt food, but impose a tax on candy, soda and prepared meals, thus requiring subtle distinctions between taxable and tax-exempt items. Similarly, most States do not tax sales of intangible property, raising issues as to whether a particular item represents taxable tangible or tax-exempt intangible property.[43] Moreover, most States provide broad taxation of personal property, but only limited taxation of services, raising issues whenever a business provides both taxable goods and tax-exempt services to a customer. For example, an automotive repair shop typically provides both goods (replacement parts) and services (labor on installation of the parts) when it repairs an automobile. Further, a State's sales tax generally does not apply to goods shipped to out-of–State customers. In such cases, the customer likely is subject to a complementary "use" tax in his or her State of residence. However, there are significant compliance problems with State use taxes.[44] Several States mail use tax forms to all State income taxpayers

[39] It is reported that there are approximately 50,000 separate sales tax jurisdictions in the United States. *Wall Street Journal*, April 18, 1990, p. A1. Alaska, Delaware, Montana, New Hampshire, and Oregon currently do not have broad-based sales taxes. The District of Columbia has a sales tax.

[40] For a detailed discussion of State and local sales taxes, see, Jerome R. Hellerstein and Walter Hellerstein, *State Taxation (Vol. II: Sales and Use, Personal Income, and Death and Gift Taxes)* (Warren, Gorham, Lamont: Boston, MA) 1992.

[41] See, for example, *Sta–Ru v. Mahin*, 64 Ill. 2d 330 (1976) and *Burger King v. State Tax Commission*, 51 N.Y. 614 (1980) (whether paper and plastic cups and similar items purchased by a fast-food restaurant were subject to State sales taxes.)

[42] See, John Due and J. Mikesell, *Sales Taxation: State and Local Structure and Administration* (1983) p.78–80.

[43] See, for example, Robert W. McGee, *Software Taxation*, National Association of Accountants, 1984, chapters 1 and 3, for a discussion of the issues involved in the application of State sales taxes to transfers of computer software.

[44] The ability of one State to require an out-of-State retailer to collect that State's sales or use tax on sales into the State (generally through mail-order catalog sales) is restricted by the Commerce Clause of the U.S. Constitution where the retailer has no physical presence in the State. See *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1976) and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

and rely upon voluntary reporting of taxable out-of–State purchases.

Description of the National Retail Sales Tax Act of 1996

Recently, there has been interest in replacing the U.S. income tax system with a Federal retail sales tax.[45] On March 6, 1996, Messrs. Schaefer, Tauzin, Chrysler, Bono, Hefley, Linder, and Stump, introduced H.R. 3039, the "National Retail Sales Tax Act of 1996" (the "Act"). Following is a discussion of the Act.

In general

The Act would impose a tax at a rate of 15 percent on gross payments for the use, consumption, or enjoyment in the United States of any taxable property or service, whether or not produced or rendered within or without the United States. In general, the tax would be imposed and remitted by the seller of the taxable item. "Taxable property or service" would mean (1) any property (including leaseholds of any term or rents with respect to such property other than intangible property), and (2) any service (including any financial intermediation services). The tax would be due when payment for the taxable item is received, even if received pursuant to an installment method. Alternatively, the seller may elect to adopt an accrual method of accounting.

Tax would not be imposed upon any property or service: (1) purchased for resale; (2) purchased to produce taxable property or service; and (3) exported from the United States for use, consumption, or enjoyment outside the United States. The tax would not be imposed with respect certain de minimis amounts. Tuition for general primary, secondary, or university level education and job-related training courses would be treated as purchased to produce taxable property or services. Special rules would apply to property or services purchased for a dual use (i.e., both a taxable and tax-exempt purpose).

Specific rules for certain transactions

Specific rules would be provided for transactions involving governmental units and not-for-profit organizations, purchases of principal residences, and financial intermediation services.[46] Specifically, any Federal, State, or local governmental unit or political subdivision would not be exempt from the tax on any sale, purchase, use, consumption, or enjoyment of a taxable good or service by the unit or subdivision. In addition, an excise tax of 15 percent would be imposed on the wages of Federal, State, and local government employees; the tax would be collected from the governmental employers.

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[45] Senator Richard Lugar had proposed that the current Federal taxes be repealed and replaced with a retail sales tax that would be collected by the States on behalf of the Federal Government. *Washington Post*, April 20, 1995. For a discussion of similar proposals, see, Laurence J. Kotlikoff, "Economic Impact of Replacing Federal Income Taxes with a Sales Tax," published by the Cato Institute in December 1992, and Stephen Moore, "The Economic and Civil Liberties Case for a National Sales Tax," published for a Hoover Institution conference on May 11, 1995.

[46] Governmental units and not-for-profit organizations, principal residences and other durable goods, and financial intermediation services present special issues under most consumption taxes. These issues will be examined in future pamphlets devoted to these topics.

Payments to a not-for-profit organization would be subject to the tax if the property or service provided in exchange for the payment is not substantially related to the exempt purpose of the organization or is commercially available. Dues, contributions, and other payments to a not-for-profit organization would not be subject to tax. For this purpose, not-for-profit organizations generally would be those organizations described in present-law sections 501(c)(3), (4), (5), (6), (8) and (10) of the Code.

A purchaser may elect to pay the tax (plus simple interest computed at the rate imposed by section 6621 of the Code) in equal installments over a 30-year period with respect to property purchased and used as a principal residence. If the property is sold or ceases to be used as a principal residence by the purchaser before the close of the 30-year period, the unpaid balance of the tax would become payable within two years of such sale or cessation.

The tax would be imposed upon explicitly and implicitly charged financial intermediation services. Explicitly charged financial intermediation services would include brokerage fees; explicitly stated banking, loan origination processing, documentation, credit check and other similar fees; safe-deposit fees; insurance fees (to the extent not allocable to the investment account of the underlying insurance policy); trustee's fees; and other financial service fees including mutual fund management, sales, and exit fees. Providers of these services would be subject to tax on the amount charged for the services. Implicitly charged financial intermediation services generally would be determined based upon the difference between the rate of interest earned on any underlying interest bearing investment and the interest paid on any underlying interest bearing debt.

Credits and rebates

The Act would provide credits with respect to sales of used property, property converted to business use, taxes collected on exempt purchases, administrative costs, compliance equipment costs, and over-collected taxes. These credits may result in a tax refund if the taxpayer files two consecutive tax reports with a credit balance. The used property tax credit is designed to alleviate the cascading of tax when taxable goods are acquired by a consumer, sold to a used goods dealer, and then resold by the dealer to another consumer. The business use conversion credit would allow a credit when a consumer devotes a previously taxed item to exclusive use in the consumer's business. The administrative credit would be an amount equal to the greater of $100 or one-half of one percent of the tax remitted by the taxpayer. The administrative credit could not exceed 20 percent of the tax remitted, determined before the application of the credit. The compliance equipment cost credit would be an amount equal to 50 percent of the cost of equipment that a vendor must purchase to comply with the requirement (described below) that the amount of tax be stated and separately charged.

The Act would provide a family consumption rebate for each qualified family unit. The amount of the rebate would be 15 percent of the lesser of: (1) the poverty level of the family, or (2) the wage income of the family unit. The qualified family unit would be

determined with respect to family members sharing a common residence. The poverty level would be the quotient of (1) the level determined by the Department of Health and Human Services poverty guidelines for family units of a particular size divided by (2) 85 percent. The size of the family unit would determined by including each spouse or head of household, child, grandchild, parent and grandparent. Family members would include certain students living away from home and exclude persons over the age of two without a bona fide Social Security number and unlawful residents of the United States. The rebate would be provided by adjusting the Social Security taxes to be withheld from the wages of employees.

Administration of the tax

The sales tax would be charged separate from the purchase price of each taxable sale. Vendors would be required to provide purchasers with a receipt that sets forth the tax-exclusive taxable item, the amount of tax paid, the tax-inclusive price of the taxable item, the tax rate, the date the item was sold, and the vendor's name and registration number.

Any person liable to collect and remit the tax who is engaged in an active trade or business would register with the appropriate taxing authority. Taxpayers would be required to pay the tax on or before the 25th day following the month in which the tax was collected, along with a report that sets forth the gross payment on taxable items for the month, the tax collected in connection with these payments, and the amount and types of credits claimed. Interest would apply to late payments. Civil or criminal penalties would apply to late filings; failures to register; and failures to collect, remit, or pay the tax.

The tax would be administered, collected, and remitted to the Federal government by an administering State within which taxable items are used, consumed, or enjoyed. A State would be an administering State if it maintains a sales tax that significantly conforms to the Federal tax and enters into a cooperative agreement with the Secretary of the Treasury regarding the State's administration of the tax. Administering States would be allowed to retain one percent of the Federal tax as an administration fee. A conforming State may contract with another conforming State to administer its sales tax. The Secretary of the Treasury would administer the tax in jurisdictions that are not administering States, where the administering State has failed on a regular and sustained basis to timely remit the tax to the United States, where the administering State has been adjudicated to have breached the cooperative agreement, and with respect to certain multistate vendors. Special rules would determine the situs of the use, consumption or enjoyment of a taxable item based on a destination principle. The Secretary of the Treasury would be required to issue guidance with respect to the tax and to establish an Office of Revenue Allocation to arbitrate claims and disputes among administering States.

Appropriations to the Internal Revenue Service ("IRS") would not be authorized after fiscal year 2000. An Excise Tax Bureau would be established to administer and collect excise tax formerly collected by the IRS, and the Social Security Administration would administer and collect payroll taxes.

2. Value-added tax

In general

A value-added tax ("VAT") generally is a tax imposed and collected on the "value added" at every stage in the production and distribution process of a good or service. Although there are several ways to compute the taxable base for a VAT, the amount of value added generally can be thought of as the difference between the value of sales (outputs) and purchases (inputs) of an enterprise.[47]

The amount of value added may be determined under a VAT in a number of ways. The two most common methods are the credit-invoice method and the subtraction method. The credit-invoice method is the system of choice in nearly all countries that have adopted a VAT,[48] while the subtraction method has been used in the States of Michigan and New Hampshire.[49] A subtraction-method VAT is also sometimes referred to as a business transfer tax.

Credit-invoice method VAT

Under the credit-invoice method, a tax is imposed on the seller for all of its sales. The tax is calculated by applying the tax rate to the sales price of the good or service and the amount of tax generally is disclosed on the sales invoice. A business credit is provided for all VAT paid on all purchases of taxable goods and services (i.e., "inputs") used in the seller's business. The ultimate consumer (i.e., a non-business purchaser), however, does not receive a credit with respect to his or her purchases. The VAT credit for inputs prevents the imposition of multiple layers of tax with respect to the total final purchase price (i.e., "cascading" of the VAT). As a result, the

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[47] Previous publications by the staff of the Joint Committee on Taxation have discussed some of the broad tax policy and economic issues to be considered in deciding whether a VAT should be enacted and have described the mechanics of various VAT systems. Numerous other publications also address these issues. See, e.g., Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax*; Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (JCS–6–91), May 30, 1991 (Part Three: "Discussion of Value–Added Taxes"), pp. 269–341; Joint Committee on Taxation, *Description of Tax Bills ... S. 442* (Value Added Tax) ... (JCS–11–89), May 11, 1989 (Part III.C., "Analysis of Specific Issues"), pp. 9–31; Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, Vol. 3, "Value–Added Tax", (1984); Congressional Budget Office, *Effects of Adopting A Value–Added Tax*, February 1992; Government Accounting Office, *Value Added Tax: Administrative Costs Vary with Complexity and Number of Businesses*, GAO/GGD–93–78, May 1993; Alan Schenk, *Value Added Tax: A Model Statute and Commentary, American Bar Association Section on Taxation*, (1989); Martin A. Sullivan, *Flat Taxes and Consumption Taxes*, American Institute of Certified Public Accountants, December 1995; Lorence L. Bravenec, *Design Issues in a Credit Invoice Method Value–Added Tax for the United States*, American Institute of Certified Public Accountants, (1990); Tax Executives Institute, *Value–Added Taxes: A Comparative Analysis*, (1992); Congressional Research Service, *Value–Added Tax: Tax Bases and Revenue Yields* (CRS Report 92–176E), November 23, 1992 (and publications cited therein); Charles E. McLure, Jr., *The Value–Added Tax: Key to Deficit Reduction?*, American Enterprise Institute for Public Policy Research, Washington, D.C. (1987); and Alan A. Tait, *Value Added Tax, International Practice and Problems*, International Monetary Fund, Washington, D.C. (1988).

[48] It is reported that Japan imposes a version of an "accounts-based" subtraction method VAT. The Japanese VAT also has elements of the credit-invoice method. See, Tax Executives Institute, *Value–Added Taxes: A Comparative Analysis* (1992), p. 80.

[49] The subtraction method has also been proposed in several recent U.S. legislative proposals. See, e.g., the business tax components of the flat taxes proposed in H.R. 2060 and S. 1050 as introduced by Mr. Armey, and Senator Specter on July 19, 1995 (described below); the "Business Transfer Tax" of S. 2160 proposed by Senators Boren and Danforth on May 26, 1994; and the business tax component of the "USA Tax" proposed in S. 722 as introduced by Senators Domenici and Nunn on April 25, 1995 (described below). In addition, Mr. Gibbons, although he has not introduced legislation to date, has supported the adoption of a VAT in his testimony before the Bipartisan Commission on Entitlements and Tax Reform on October 6, 1994, the Committee on Ways and Means in 1995, and in various writings.

net tax paid at a particular stage of production or distribution is based on the value added by that taxpayer at that stage of production or distribution. In theory, the total amount of tax paid with respect to a good or service from all levels of production and distribution should equal the sales price of the good or service to the ultimate consumer multiplied by the VAT rate.

In order to receive an input credit with respect to any purchase, a business purchaser generally is required to possess an invoice from a seller that contains the name of the purchaser and indicates the amount of tax collected by the seller on the sale of the input to the purchaser. At the end of a reporting period, a taxpayer may calculate its tax liability by subtracting the cumulative amount of tax stated on its purchase invoices from the cumulative amount of tax stated on its sales invoices.

Example 1. Simple credit-invoice method VAT.—Assume a landowner sells felled trees to a paper mill for $1,000. The landowner had not been subject to tax with respect to anything used in the production of the trees. The paper mill processes the trees into rolls of paper and sells the rolls to a distributor for $1,300. The distributor cuts the rolls into sheets, packages the sheets, and sells the packages to a retail stationery store for $1,500. The retail stationery store sells the entire lot of packages to nonbusiness consumers for $2,000. The jurisdiction in question levies a broad-based VAT at a rate of 10 percent. The tax would be determined as follows:

Production stage	Sales		VAT on sales		VAT on purchases		Net VAT
Landowner	1,000 x .1	=	100		−(0)	=	100
Paper mill	1,300 x .1	=	130		−(100)	=	30
Distributor	1,500 x .1	=	150		−(130)	=	20
Retail store	2,000 x .1	=	200		−(150)	=	50
Total			580		−(380)	=	200

Thus, a total of $200 of VAT is assessed and collected in various amounts from the four stages of production. If, instead of a VAT, the jurisdiction in question levied a retail sales tax at a rate of 10 percent, the total amount of tax also would be $200 ($2,000 sales times 10 percent), all collected by the stationery store at the retail level.

Subtraction-method VAT

Under the subtraction method, value added is measured as the difference between an enterprise's taxable sales and its purchases of taxable goods and services from other enterprises. At the end of the reporting period, a rate of tax is applied to this difference in order to determine the tax liability. The subtraction method is similar to the credit-invoice method in that both methods measure value added by comparing outputs (sales) to inputs (purchases) that have borne the tax. The subtraction method differs from the credit-invoice method principally in that the tax rate is applied to

a net amount of value added (sales less purchases) rather than to gross sales with credits for tax on gross purchases (as under the credit-invoice method). The determination of the tax liability of an enterprise under the credit-invoice method relies upon the enterprise's sales records and purchase invoices, while the subtraction method may rely upon records that the taxpayer maintains for income tax or financial accounting purposes.

Example 2. Simple subtraction method VAT.—Assume the same facts as in Example 1 above. The subtraction method VAT would operate as follows:

Production stage	Sales − Purchases	=	Value added x rate	=	VAT
Landowner	1,000	−(0)	= 1,000 x .1	=	100
Paper mill	1,300	−(1,000)	= 300 x .1 ...	=	30
Distributor	1,500	−(1,300)	= 200 x .1 ...	=	20
Retail store ...	2,000	−(1,500)	= 500 x .1 ...	=	50
Totals			= 2,000 x .1	=	200

Comparing Examples 1 and 2, the credit-invoice and subtraction methods yield the same amounts of tax at the same levels of production.

Exclusions under a VAT

Most VATs adopted to date provide special treatment for imported and exported goods and services.[50] In addition, most VATs provide exclusions for various goods and services, or classes of taxpayers for economic, social, or political reasons. In addition, certain goods and services are excluded from the VAT due to difficulties in measuring either the amount of the value added or the element of consumption (as opposed to the investment element) with respect to the good or service.

Goods, services, or classes of taxpayers may be excluded from a VAT either by providing a "zero rating" or an exemption. There may be significant differences between these two alternatives, particularly under the credit-invoice method. If a sale is zero-rated, the sale is considered a taxable transaction, but the rate of tax is zero percent. Sellers of zero-rated goods or services do not collect or remit any VAT on their sales of those items, but are required to register as taxpayers. Sellers of zero-rated items are allowed to claim credits (and perhaps a refund to the extent the taxpayer does not have taxable sales) for the VAT they paid with respect to purchased goods and services.

Similarly, a seller of goods or services that is exempt is not required to collect any VAT on its sales. However, because such sellers are not considered taxpayers under the VAT system, they may not claim any refunds of the VAT that they may have paid on their purchases. In addition, under the credit-invoice method, purchasers of exempt goods or services generally are not allowed a credit for any VAT borne with respect to such goods or services prior to the

[50] See the following discussion for the general treatment of imported and exported goods and services under consumption taxes.

exempt sale. Consequently, a VAT exemption, as opposed to a zero rating, in a credit-invoice system breaks the chain between inputs and outputs along the various stages of production and distribution and may result in a cascading of the tax (i.e., total tax collected from all stages of production would be greater than the retail sales price of the good times the VAT rate). For this reason, most VAT commentators, while recognizing that exemptions may be useful in easing the administrative and recordkeeping burdens of certain targeted taxpayers or transactions (such as small businesses or casual sales), prefer zero rating as the means of providing VAT relief under the credit-invoice method.

There is little practical experience available to assess how exclusions would operate under a subtraction-method VAT. It is, however, theoretically possible to design exclusions under either a subtraction method that replicate the effects of zero rating or exemptions under a credit-invoice VAT. Moreover, exemptions under the subtraction method may relieve the tax on the value added by the exempted activity, but do not result in the cascading that occurs with exemptions under the credit-invoice method.

Border adjustments

A VAT based on the destination principle imposes tax on imports and provides tax rebates on exports. These import charges and export rebates are commonly referred to as "border adjustments" and are a part of nearly all VAT systems currently in place.[51]

Under the border adjustments, exported goods would not be subject to the VAT through zero-rating the sale of exported goods (i.e., by applying a VAT rate of zero to exports, thus allowing the exporter to claim refundable credits for VAT paid with respect to the purchased inputs). On the other hand, importers would be subject to tax on the full value of imported goods (because inputs with respect to such products previously had not been subject to the U.S. VAT). Similar treatment would be provided for imported and exported services.[52]

Border adjustments are fully consistent with the General Agreement on Tariffs and Trade (GATT), as long as they do not discriminate against imports or provide over-rebates on exports. Relief from "indirect" taxes on exports does not constitute an illegal export subsidy, while relief from "direct" taxes (such as income taxes) is illegal. "Indirect" taxes are defined to include value-added taxes, and credit-invoice VATs have been accepted as border-adjustable under GATT. Although a subtraction-method VAT has the same base as a credit-invoice VAT, it is not clear whether a subtraction-method

[51] A discussion of border adjustments under a consumption tax.

[52] The cross-border provision of services presents difficult issues under any VAT. Services may be performed in whole or in part in one jurisdiction and used or providing benefits in another. Theoretically, (1) services performed by a person outside the United States but used or providing benefits in the United States would be subject to the United States VAT, (2) services performed by a United States person but used or providing benefits in a foreign country would not be subject to the United States VAT, and (3) the value of services used within and without the United States would be allocated between the two jurisdictions based on the relative values of such services. In the case of services, as demonstrated by the present-law income tax controversies surrounding Internal Revenue Code section 482, the identification, measurement, and valuation of use or the benefits provided is difficult. Certain services that are provided both within and without the United States, such as international transportation or communication, could be allocated pursuant to statutory (although somewhat arbitrary) ratios, as under the present-law income tax.

VAT is an indirect tax and whether border adjustments under the subtraction-method are GATT-legal.[53] Further, because there are no pure subtraction-method VATs currently in existence, there have been no GATT challenges or test cases with respect to the legality of subtraction method border adjustments.

3. Consumption-based "flat" tax

In general

A "flat tax" generally is any tax system with only one marginal tax rate.[54] For example, one could construct a flat tax out of the current individual income tax by eliminating all but one marginal rate bracket and repealing provisions that impose higher marginal rates by reducing other deductions or exclusions (e.g., the personal exemption phaseout and the limitation on itemized deductions). While such a tax would be a flat tax on the basis of its single rate bracket, it would still contain dozens of tax expenditure provisions, including the home mortgage interest deduction, the charitable contribution deduction, the deduction for State and local income taxes, the earned income tax credit, and the dependent care credit.

Many of the flat tax proposals that have been developed do more than simply apply one rate to the current individual income tax base. In addition, they redefine the base of the tax. As discussed above, there are two main approaches: a consumption base and an income base. The gross income of a taxpayer in any year can be thought of as the sum of the taxpayer's consumption and gross saving. The difference between these two approaches is in the treatment of saving. An income-based tax includes the return to saving in the tax base; a consumption-based tax does not.

Recently proposed flat taxes—H.R. 2060 and S. 1050

There have been several consumption-based flat taxes introduced in recent Congresses.[55] On March 2, 1995, Senator Arlen Specter introduced S. 488. On January 4, 1995, Congressman Philip Crane introduced H.R. 214, "The Tithe Tax," in the House of Representatives. In the 103rd Congress, on January 26, 1993, Senator Jesse Helms introduced S. 188, "The Tithe Tax;" and on June 16, 1994, Congressman Richard Armey introduced H.R. 4585, "The Freedom and Fairness Restoration Act of 1994." House Majority Leader Armey modified his flat tax proposal and introduced H.R. 2060 on July 19, 1995. Senator Richard Shelby introduced a companion bill, S. 1050, in the Senate on the same date. The subsequent discussion provides a description of H.R. 2060 and S. 1050.

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[53] See, e.g., George N. Carlson and Richard A. Gordon, "VAT or Business Transfer Tax: A Tax on Consumers or on Business?" *Tax Notes*, October 17, 1988, p. 329.

[54] A bracket with a marginal rate of zero could also be provided by allowing a standard deduction and personal exemptions. As long as only one bracket has a marginal tax rate greater than zero, the tax would commonly be referred to as a "flat tax."

[55] The bills describe flat taxes because the taxes would be imposed at a single rate on taxable income. These flat taxes generally may be described as consumption-based because in determining taxable income, returns on investment assets would be excluded and businesses would be allowed to expense the cost of capital assets.

Overview

H.R. 2060 and S. 1050 are based on a flat tax developed by Professors Robert Hall and Alvin Rabushka of Stanford University.[56] In general, the tax described in the bills is a consumption-based flat tax that is imposed at single rate upon individuals and businesses. An individual is taxed on the amount by which the individual's wages and distributions from qualified plans exceed the individual's standard deduction. The business activities tax proposed by the bills resembles a subtraction-method VAT, as described above. The difference between the bills' business activities taxes and a subtraction-method VAT is that the bills would allow businesses to deduct compensation expenses, while VATs generally do not allow compensation deductions. However, under the bills, the receipt of such compensation is subject to tax at the individual level at the same flat rate applicable to businesses. Thus, the combination of the business activities tax and the individual tax is roughly equivalent to a VAT. The combination of the individual and business taxes under H.R. 2060 and S. 1050 is not exactly equivalent to a VAT because of the allowance for standard deductions under the individual-level tax. Alternatively, the bills could be viewed as a VAT that provides individuals with built-in exemptions for a minimum amount of consumption.[57] Following is a more detailed description of the bills.

Taxation of individuals

The bills would impose a tax equal to 20 percent (the tax rate is reduced to 17 percent for taxable years beginning after December 31, 1997) of the excess (if any) of: (1) certain earned income received during the taxable year over (2) the standard deduction for the year. For this purpose, earned income subject to tax would be wages paid in cash for services provided in the United States, distributions from retirement plans, and unemployment compensation.

Under the bills, the "standard deduction" would be the sum of a "basic standard deduction" plus the "additional standard deduction." As under present law, the amount of the basic standard deduction would be determined based on the individual's filing status as provided in Table 1 below. (For the sake of comparison, the amounts of standard deductions allowable under present law also are provided in the table.)

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[56] See, Robert E. Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax*, (New York: McGraw–Hill), 1983.

[57] As described by Robert E. Hall and Alvin Rabushka in *The Flat Tax: A Simple Progressive Consumption Tax*, a paper prepared for a Hoover Institution conference of May 11, 1995, the exemption amounts of their proposed flat tax are intended to provide relief for lower income individuals under their consumption-based tax.

Table 1.—Comparisons of "Standard Deductions" Under H.R. 2060, S. 1050, and Present Law

Filing status [1]	H.R. 2060 and S. 1050 basic standard deduction	Present-law standard deduction [2]
Joint return	$21,400	$6,550
Surviving spouse	21,400	6,550
Head of household	14,000	5,750
Married filing separately	10,700	3,275
Single	10,700	3,900

[1] The determination of an individual's filing status under the bills is the same as under present law.

[2] The amounts in Table 1 provided above for the standard deductions apply for calendar year 1995. These amounts are indexed annually for inflation.

In addition, individuals who are blind or age 65 or older may increase their standard deductions under present law. These additional deduction amounts are not provided under the bills.

Under the bills, the "additional standard deduction" would be an amount equal to $5,000 multiplied by the number of dependents of the taxpayer. (Under present law, a $2,500 exemption amount is allowed for calendar year 1995 for the taxpayer, his or her spouse, and each dependent of the taxpayer. The exemption amounts are indexed annually for inflation.) Similar to present law, basic standard deduction and the additional standard deduction amounts under the bills would be indexed for inflation.

Taxable income of an individual would include the otherwise taxable income of his or her dependent children under the age of 14.

Taxation of business activities

The bills would impose a tax equal to 20 percent (the tax rate is reduced to 17 percent for taxable years beginning after December 31, 1997) of the business taxable income of a person engaged in a business activity. The tax would be imposed on the person engaged in a business activity, whether such person is an individual, partnership, corporation, or otherwise. For this purpose, "business taxable income" would mean gross active income reduced by specified deductions. "Gross active income" would mean gross receipts from (1) the sale or exchange of property or service in the United States by any person in connection with a business activity and (2) the export of property or services from the United States in connection with a business activity.

The bills would allow deductions for (1) the cost of business inputs for the business activity, (2) wages paid in cash to employees for the performance of services in the United States, and (3) contributions to qualified retirement plans or arrangements. For this purpose, "the cost of business inputs" would mean (1) the amount paid for property sold or used in connection with a business activity, (2) the amount paid for services (other than for services of employees, including fringe benefits), and (3) any excise tax, sales tax, customs duty or other separately stated levy imposed by a Federal, State, or local government on the purchase of property or service

used in connection with a business activity (other than the flat tax).

If a taxpayer's aggregate deductions for any taxable year exceed its gross active income for the year, the amount of deductions allowed for the succeeding taxable year would be increased by the sum of (1) the excess, plus (2) the product of the excess and the three-month Treasury rate for the last month of the taxable year.

The bills would provide special rules for financial intermediation service activities and noncash compensation provided by employers not engaged in a business activity. The taxable income from the business activity of providing financial intermediation services would be the value of such services.

Governmental entities and other tax-exempt organizations would not be subject to the business activities tax. However, these entities would be subject to a tax equal to 20 percent (the tax rate is reduced to 17 percent for taxable years beginning after December 31, 1997), on the amount of remuneration for services performed by an employee other than wages, remuneration for services performed outside the United States, or retirement contributions to qualified plans or arrangements.

Treatment of qualified retirement plans

The bills would make several changes to the present-law treatment of qualified retirement plans. The bills generally would retain the present-law tax treatment of employer-provided retirement plans, but would liberalize the qualification rules. For example, nondiscrimination rules, limits on contributions, and the excise tax on excess distributions would be repealed.

4. Cash flow tax

In general

A cash flow tax is a personal consumption tax imposed on the net cash flow of an individual taxpayer. The base of the tax is determined by subtracting a deduction for net increases in savings from the gross income of the taxpayer. Under a pure cash flow tax, withdrawals from savings and net borrowings would be treated as gross income. Thus, a cash flow tax differs from a consumption tax such as a retail sales tax in that the cash flow tax can be levied and collected from individual taxpayers rather than businesses. This personalization of the tax can measure the consumption of an individual taxpayer and allows the application of a progressive rate structure.

Description of the "USA Tax Act of 1995"

Overview

On April 25, 1995, Senators Sam Nunn and Pete Domenici introduced a form of a cash flow tax in S. 722, (the "USA Tax Act of 1995"). In general, S. 722 would replace the current individual income tax with a "savings-exempt income tax"—a broader-based individual income tax with an unlimited deduction for net new saving. The tax would be imposed using a three-tier graduated rate schedule. In addition, S. 722 would replace the current corporate income tax with a subtraction-method VAT imposed on all busi-

nesses at a rate of 11 percent. Thus, in general, the bill would apply two different consumption-based taxes—a cash flow tax on individuals and a VAT on businesses. The bill also would provide individuals with a refundable credit against the individual tax for employee payroll taxes paid by them, and businesses with a credit against the business tax for employer payroll taxes paid by them. Following is a more detailed description of the bill.

Treatment of individuals under the "savings exempt income tax"

The individual tax, or "savings exempt income tax," would be a broad-based income tax with an unlimited deduction for new savings. In other words, it is a modified version of a personal consumption tax with one principal distinction. As discussed in more detail below, borrowing would not be included in income, but rather would only reduce (but not below zero) the net saving deduction. Thus, unlike a personal consumption tax, a net borrower would not pay tax on an amount greater than his income in a given year, even though the net borrowing reflects additional consumption. This additional consumption generally would be taxed as the loan is repaid.

The individual tax would have a three-tier graduated tax rate structure. As under present law, separate rate schedules would apply based on an individual's filing status. The rate structure would be phased-in from 1996 to 1999. After 1999, the individual income tax rate schedules are as follows:

Table 2.—Individual Income Tax Rates Under S. 722[1]

If taxable income is	Then income tax equals
	Single individuals
$0–$3,200	8 percent of taxable income.
$3,200–$14,400	$320 plus 19% of the amount over $3,200.
Over $14,400	$2,560 plus 40% of the amount over $14,400.
	Heads of households
$0–$4,750	8 percent of taxable income.
$4,750–$21,100	$380, plus 19% of the amount over $4,750.
Over $21,100	$3,486.50, plus 40% of the amount over $21,100.
	Married individuals filing joint returns
$0–$5,400	8 percent of taxable income.
$5,400–$24,000	$432, plus 19% of the amount over $5,400.
Over $24,000	$3,966, plus 40% of the amount over $24,000.
	Married individuals filing separate returns
$0–$2,700	8 percent of taxable income.
$2,700–$12,000	$216, plus 19% of the amount over $2,700.

Table 2.—Individual Income Tax Rates Under S. 722[1]—Continued

If taxable income is	Then income tax equals
Over $12,000	$1,983, plus 40% of the amount over $12,000.

[1] The rate schedules are expressed in 1996 dollars and would be indexed for inflation beginning in 1997.

Gross income would be defined broadly to include salaries and wages, pensions, most fringe benefits, annuities, life insurance proceeds, alimony and child support payments, dividends, distributions from partnerships and proprietorships, rents, royalties, interest (other than tax-exempt interest), includible social security benefits, and proceeds from the sale of assets. Exclusions from gross income would be limited to tax-exempt bond interest,[58] gifts and bequests, certain government transfer and similar payments, certain health care payments and reimbursements, certain military pay and veteran's benefits, and a portion of social security payments (generally as under present law).

An individual would be allowed a deduction for any increase in his or her "net savings" during the year. "Net savings" would be the taxpayer's additions to qualified savings assets during the year over taxable withdrawals from qualified savings assets during the year. An annual decrease in net savings would constitute taxable income. Borrowing would not be treated as a withdrawal from saving, but generally would reduce (but not below zero) the amount of "net savings" that could be deducted in a taxable year.[59]

Qualified savings assets would include stocks, bonds, securities, certificates of deposits, interests in proprietorships and partnerships, mutual fund shares, life insurance policies, annuities, retirement accounts, and bank, money market, brokerage and other similar money accounts. Qualified savings assets would not include investments in land, collectibles, or cash on hand.

Under the bill, in addition to certain itemized deductions (discussed below) each taxpayer would be entitled to two types of standard deductions: (1) a family living allowance, and (2) a personal and dependency deduction. The family living allowance and the personal and dependency deductions under the bill are comparable to the standard deductions and personal exemptions of present law, respectively.

The bill would continue to allow deductions for qualified home mortgage interest[60] and charitable contributions. In contrast to current law, these itemized deductions would be allowed in addition to the standard deduction, rather than in lieu of the standard deduction. Other deductions allowable under present law generally would be eliminated, such as itemized deductions for state and

[58] This exemption may be worth less than relative to present law, because the "tax" on taxable interest may be deferred under the savings deduction.

[59] Certain types of debt would not reduce deductible "net savings" in a taxable year, including mortgage debt on a principal residence, debt (of $25,000 or less) to purchase consumer durables, credit card and similar debts, and $10,000 of other debts.

[60] The home mortgage deduction generally would be the same as under present law, except that no deduction would be allowed for "home equity indebtedness." *Cf.* Sec. 163(h)(3).

local taxes and medical expenses. The bill would allow a new deduction for certain qualified educational expenses. This deduction generally would be limited to $2,000 per eligible student per year, and to $8,000 in total per year.

The bill would allow certain credits against the amount of tax due. First, a foreign tax credit would be allowed in a manner similar to present law. Second, a credit generally would be allowed for the employee share of payroll taxes paid by the taxpayer. Third, for low-income individuals, an earned income credit similar to present law would be allowed.

The bill provides certain transition rules (e.g., pre-transition recovery of basis) for purposes of the individual tax. A discussion of these rules is beyond the scope of this pamphlet.[61]

Business tax

The bill would impose a subtraction-method VAT on any business that sells or leases property or sells services in the United States. The tax would equal 11 percent of the "gross profits" of the business for the taxable year. "Gross profits" generally is the amount by which the taxpayer's taxable receipts exceed the taxpayer's business purchases for the taxable year. If the taxpayer's business purchases exceed its taxable receipts for the taxable year, the taxpayer generally would be entitled to a loss carryover to future taxable years. Employer payroll taxes paid by the business may be credited against the business tax.

"Taxable receipts" generally mean all receipts from the sale or lease of property, and the performance of services in the United States. The amount treated as taxable receipts from the exchange of property or services is the fair market value of the property or services received, plus any cash received. Taxable receipts do not include: (1) any excise tax, sales tax, customs duty, or other separately stated levy imposed by the Federal, a State, or a local government on property or services, or (2) financial receipts, such as interest, dividends, proceeds from the sale of stock or other ownership interests.

"Business purchases" generally mean any amount paid or incurred to purchase property, the use of property or services for use in a business activity in the United States other than: (1) compensation paid to employees; (2) payments for use of money or capital, such as dividends or interest, (3) life insurance premiums; (4) amounts paid for the acquisition of savings assets or financial instruments; and (5) amounts paid for property purchased or services performed outside the United States (unless treated as an import). The cost of a business purchase does not include any taxes other than any excise tax, sales tax, customs duty, or other separately stated levy imposed by the Federal, a State, or a local government with respect to the property or services purchased for use in a business activity. "Business activity" means the sale of property or services, the leasing of property, and the development of property or services for subsequent sale or use in producing property or

[61] Transition issues under tax restructuring proposals will be the subject of a future staff hearing pamphlet.

services for subsequent sale. A business activity would not include casual or occasional sales of property.

The business tax generally is based on the destination principle—goods and services are subject to tax in the country in which they are used rather than in their country of origin. Under the destination principle, imported goods and services are subject to tax while exported goods and services are not.

In computing its gross profits, a taxpayer generally would be required to use an accrual method of accounting. For this purpose, an amount would not be treated as incurred earlier than when "economic performance" with respect to the item has occurred (Code sec. 461(h)). Businesses presently using the cash receipts and disbursements method, however, generally could continue to use that method. The Secretary of Treasury also could allow certain new businesses to use the cash method. The taxpayer's method of accounting could be changed only with the permission of the Secretary. Special accounting rules would apply with respect to property produced pursuant to long-term contracts.

The bill would impose the business tax on the provision of financial intermediation services. Special rules would apply to determine the taxable amount derived from financial intermediation services. In addition, the bill would permit the business user of financial intermediation services to deduct as business purchases any stated fees for such services and any implicit fees allocated and reported to it by the financial intermediary. The bill would provide a method (and reporting mechanism) for allocating the value of financial intermediation services among users of the services.

Government entities would not be subject to the business tax with respect to the following activities: (1) public utility services; (2) mass transit services; and (3) any other activity involving an "essential governmental function." Any other government activity of a type "frequently provided by business entities" would be subject to tax. The governments of possessions of the United States would not be subject to the business tax.

The bill generally would exempt the following types of entities from the business tax: (1) instrumentalities of the United States, (2) organizations described in present-law section 501(c)(3)[62], (3) certain qualified benefit plans and trusts, (4) religious and apostolic organizations, (5) cemetery companies, (6) certain title and real property holding companies, (7) cooperative hospital service organizations, and (8) cooperative educational service organizations. These entities would be subject to the business tax only with respect to their business activities that would be subject to the unrelated business income tax ("UBIT") under present law. The taxable amount for a "UBIT activity" would be determined in the same manner as the taxable amount for any other business activity subject to the business tax.

Entities (other than those listed above) that are tax-exempt under present law would be fully subject to the business tax on transfers of property or furnishing of services, even if such activi-

[62] The bill, however, would not exempt organizations that test for public safety or foster amateur sports competition.

ties are substantially related to what historically has been considered to be the exempt purposes of these organizations.

The bill would provide certain transition rules (e.g., recovery of pre-transition basis) for purposes of the business tax. These rules are beyond the scope of this pamphlet.

5. A "pure" income tax

In general

Under a "pure" income tax, all income would be subject to tax and deductions would be allowed only for expenses that are incurred in the production of income. Income would be recognized when earned and deductions generally would be matched with the accounting period in which the related income is recognized.

A significant portion of the current U.S. tax system generally is considered to be an "income tax."[63] Code section 61 subjects to tax "income from whatever source derived," except for certain items explicitly exempted or excluded by statute. However, the current Federal "income" tax has features that are consumption-based. For example, present law excludes from income contributions to, and earnings of, qualified retirement plans. These exclusions are features of a consumption-based tax because of their treatment of savings.

Similarly, the current Federal income tax allows certain deductions in a manner similar to the way such deductions are allowed under a consumption-based tax. For example, under a value-added tax or consumption-based flat tax, businesses are allowed to expense the cost of property used in the business (such as machinery, equipment, real property, and inventory) in the year such costs are paid or incurred. Expensing is equivalent to excluding from tax the expected return from the property because the cost of such property is equal to the present value of the expected stream of income from the property. Under a "pure" income tax, costs of property that benefit future accounting periods are capitalized and recovered over such periods. Under present law, certain costs are expensed in the period they are incurred even though such costs may benefit future periods and would be capitalized under a "pure" income tax. Examples of such expenditures include up to $17,500 of the cost of tangible personal property of small business, the cost of clean-fuel vehicles and refueling property, intangible drilling costs, research and experimental expenditures, expenditures to increase the circulation of newspapers, magazines and periodicals, certain timber expenditures, certain expenditures of farmers, costs of removing architectural and transportation barriers to the handicapped and elderly, certain mining expenditures, and certain costs incurred by free lance authors, photographers, and artists. In addition, present law allows certain capitalized costs to be recovered more rapidly than would be allowed under a "pure" income tax. For example, present law allows the cost of tangible personal property to be depreciated using accelerated methods over periods that may be

[63] In 1994, 54.34 percent of Federal receipts came from individual and corporate income taxes, 36.69 percent came from payroll taxes, 4.39 percent came from excise taxes, and 4.58 percent came from other sources. Joint Committee on Taxation, *Selected Materials Relating to the Federal Tax System Under Present Law and Various Alternative Tax Systems* (JCS–1–96), March 14, 1996, pp. 5–8.

shorter than the useful lives of the property. Expensing or accelerated cost recovery is provided under present law for certain expenditures in order to simplify the tax accounting for such costs or to provide a tax benefit or incentive for particular activities or types of taxpayers.

Certain exemptions, exclusions, deductions, special rates, and credits are provided in the current Federal income tax largely to promote social, economic, or intragovernmental policies, rather than to contribute to a more accurate measure of economic income. Examples of such items include itemized deductions for medical expenses, home mortgage interest, charitable contributions, State and local income taxes,[64] and property taxes; percentage depletion in excess of cost for natural resources; the exclusion from income for employer-provided health insurance and other fringe benefits; the exclusion of interest on State and local bonds; special rules applicable to military personnel; parsonage allowances for clergy; the special rate of tax on long-term capital gains; and most tax credits. Similarly, present law denies tax deductions for certain trade or business expenses for social policy reasons. Examples include the denial of deductions for penalties, fines, bribes, lobbying activities, and compensation in excess of $1 million for certain executives.

Finally, certain provisions of present law are provided for administrative convenience even though such provisions may result is in a mismeaurement of economic income.

Several adjustments could be made to the present-law tax system to arrive at a more "pure" income tax. The base of the income tax could be expanded to be more comprehensive. A comprehensive income base would include income from all sources, whether labor income or returns to saving. Sources of income currently excluded from tax, such as employer-provided health insurance and interest from State and local bonds, would be included in the base. Items currently given consumption-base treatment in the individual income tax would be put on an income base. For example, contributions by an employer on behalf of an employee to a qualified retirement plan and earnings on contributions would be taxed currently. Long-term capital gains would be treated the same as ordinary income. Present-law conventions that result in the deferral of income could be repealed in order to result in a more accurate measure of economic income. For example, under present law, capital gain on an investment generally is recognized when the investment is sold. Present law could be amended to require capital gains to be recognized as such income accrues by marking the investment to market on an annual basis. Such a proposal would raise administrative and liquidity concerns.

Under a more comprehensive income tax, deductions would be allowed only for expenditures that are incurred for the production of income. Thus, most present-law itemized deductions would be repealed. Deductions would be allowed to the extent necessary to accurately measure annual economic income. Thus, expenditures that benefit future accounting periods would be capitalized and recovered in the appropriate period. In general, the tax base for business

[64] Deductions also may be allowed for State and local income tax for income measurement purposes.

income would more closely resemble the present-law corporate alternative minimum tax base.

Ten percent tax plan

The Treasury Department described a more comprehensive income tax base in its study of tax reform in the early 1980s.[65] Portions of this were enacted as part of the Tax Reform Act of 1986, which broadened the tax base while lowering ordinary income tax rates. More recently, the House Minority Leader (Mr. Gephardt) has proposed an individual income tax (the "Ten Percent Tax Plan") with a more comprehensive base.[66] Under the proposal, interest income on State and local bonds, employer-provided fringe benefits (primarily health insurance), and employer pension contributions would be subject to tax. The foreign earned income exclusion (section 911 of the Code), deductions for IRA and Keogh contributions, and the deduction for self-employed health insurance would be eliminated. The only itemized deduction allowed under the plan would be the mortgage interest deduction. Deductions for investment interest and job-related expenses would be retained. The individual tax rates that would be applied to this expanded income base would be reduced from a range of 15 to 39.6 percent to range of 10 to 34 percent. The special capital gains rate would be repealed. The proposal would repeal the child care and elderly credit while retaining the earned income and foreign tax credits.

6. Summary of treatment of various items under alternative tax systems

The following charts generally describe the treatment of certain common items of income and expense under various alternative tax systems. The charts describe how taxpayers would treat these items on their own tax return. The treatment of items under "national retail sales tax" is based upon H.R. 3039. The "value-added tax" is based upon the Business Activities Tax of S. 2160, as introduced. The "consumption-based flat tax" is based upon H.R. 2060 and S. 1050, as introduced. The "USA Tax" is based upon S. 722, as introduced. The description of the "pure income tax" is based upon a theoretical model for such a system.

[65] Department of the Treasury, *Tax Reform for Fairness, Simplicity and Economic Growth, Vol. 1*, 1984.

[66] See, press release dated January 17, 1996. The Ten Percent Tax Plan has not been introduced as a bill nor has statutory language for the plan been released.

Chart 1.–Treatment of Income of Individuals Under Various Tax Systems

	National Retail Sales Tax	Value-Added Tax (VAT)	Consumption-based Flat Tax (Armey/Shelby)	Nunn-Domenici USA Tax	Present Law Inc. Tax	"Pure" Income Tax
INCOME:						
Wages\Salaries	N/A	N/A	Includible	Includible	Includible	Includible
Retirement Benefits (incl. inside build-up)	N/A	N/A	Includible when Received	Includible when Received	Includible when Received	Includible when Earned
Social Security Benefits	N/A	N/A	Not Includible	Partially Includible	Partially Includible	Includible
Unemployment Compensation	N/A	N/A	Includible	Includible	Includible	Includible
Employer-paid Health Care	N/A	N/A	Not Includible	Includible	Not Includible	Includible
Dividends	N/A	N/A	Not Includible	Includible	Includible	Includible
Interest	N/A	N/A	Not Includible	Includible	Includible	Includible
Municipal Interest	N/A	N/A	Not Includible	Not Includible	Not Includible	Includible
Capital Gains	N/A	N/A	Not Includible	Includible	Includible	Includible
Business, Farm, Partnership, & Sub S Income	N/A	N/A	Subject to Business Tax	Includible	Includible	Includible
Rental & Royalty Income	N/A	N/A	May be subject to Business Tax	Includible	Includible	Includible
Alimony	N/A	N/A	Not Includible	Includible	Includible	Includible
Child Support	N/A	N/A	Not Includible	Includible	Not Includible	Includible

Chart 2.–Treatment of Deductions of Individuals Under Various Tax Systems

	National Retail Sales Tax	Value-Added Tax (VAT)	Consumption-based Flat Tax	Nunn-Domenici USA Tax	Present Law	Income-based Flat Tax
DEDUCTIONS:						
IRA & Savings Contributions	N/A	N/A	Not Deductible	Unlimited Ded. for Savings	Ded. within limits	Not Deductible
Alimony	N/A	N/A	Not Deductible	Deductible	Deductible	Deductible
Child Support	N/A	N/A	Not Deductible	Deductible	Not Ded.	Deductible
Moving Expense	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
Medical	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
State/Local Taxes	N/A	N/A	Not Deductible	Not Ded.	Deductible	Not Ded.
Real Estate Taxes	N/A	N/A	Not Deductible	Not Ded.	Deductible	Not Ded.
Mortgage Int.	N/A	N/A	Not Deductible	Deductible	Deductible	Not Ded.
Investment Int.	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
Charitable Contributions	N/A	N/A	Not Deductible	Ded. within limits	Ded. within limits	Not Deductible
Casualty Losses	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
Employee Business Exp.	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
Investment Exp.	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
Education Exp.	N/A	N/A	Not Deductible	Deductible w/in limits	Generally not ded.	Not Deductible

Chart 3.--Treatment of Businesses Under Various Tax Systems

	National Retail Sales Tax	Value-Added Tax (VAT)	Consumption-based Flat Tax	Nunn-Domenici USA Tax	Present Law Inc. Tax	"Pure" Income Tax
INCOME:						
Gross Receipts from Sales of Goods/Services	Retail Sales Only	Includible	Includible	Includible	Includible	Includible
Interest	Not Incl.	Not Incl.	Not Incl.	Not Incl.	Includible	Includible
Dividends	Not Incl.	Not Incl.	Not Incl.	Not Incl.	Partially Includible	Includible
Capital Gains	Not Incl.	Not Incl.	Not Incl.	Not Incl.	Includible	Includible
Proceeds from Sales of Business Assets	Not Incl.	Includible	Includible	Includible	Includible	Includible
Rental & Royalty Income	Not Incl.	Incl. if trade or business	Incl. if trade or business	Incl. if trade or business	Includible	Includible
DEDUCTIONS:						
Inventory	Not Ded.	Ded. when acquired	Ded. when acquired	Ded. when acquired	Ded. when sold	Ded. when sold
Cost Recovery of Property	Not Ded.	Expensed when acquired	Expensed when acquired	Expensed when acquired	Deprec. over time	Depreciate over time
Payments to Indep. K'ors	Not Ded.	Deductible	Deductible	Deductible	Deductible	Deductible
Salaries/Wages	Not Ded.	Not Ded.	Deductible	Not Ded.	Deductible	Deductible
Retire. Benefits	Not Ded.	Not Ded.	Deductible	Not Ded.	Deductible	Deductible
Employee Health	Not Ded.	Not Ded.	Not Ded.	Not Ded.	Deductible	Deductible
Taxes	Not Ded.	Not Ded.	Not Ded.	Not Ded.	Deductible	Deductible
Interest	Not Ded.	Not Ded.	Not Ded.	Not Ded.	Deductible	Deductible
Charitable Contributions	Not Ded.	Not Ded.	Not Ded.	Not Ded.	Ded. with limits	Deductible
Advertising	Not Ded.	Deductible	Deductible	Deductible	Deductible	Deductible

C. Data on Small Businesses

1. Classification of firms by various characteristics

Table 3 shows data from the Internal Revenue Service's Statistics of Income ("SOI") regarding the number of tax returns filed by different forms of business organizations from 1978 to 1993. Throughout the period, nonfarm sole proprietorships made up the vast majority of businesses. In 1993, they were nearly three-quarters of the total; over the 16 years, they were never lower than 69 percent of the total.[67] While the relative share of nonfarm sole proprietorships increased after 1986, the growth rate in their numbers did not rise from that of earlier periods and has in fact slowed in the 1990s. The increase in the relative share of nonfarm sole proprietorships is an artifact of the decline in the absolute number of partnerships and C corporations following the Tax Reform Act of 1986. The number of each of those forms has declined in every year since 1986. At the same time, the number of S corporations has increased more than twofold. The growth in the number of S corporations was most dramatic immediately following 1986; in the past few years, growth rates have returned to the range of pre–1986 growth rates. The number of S corporations also grew rapidly following the Subchapter S Revision Act of 1982.[68]

[67] Farming sole proprietorships (returns that filed Schedule F) are not included in the time series in Table 3 and thus are not shown in the total. In 1993, there were 2,292,908 farming sole proprietorships, exceeding the number of either C corporations, S corporations, or partnerships.

[68] For details on the changes in S corporation law over the 1980s, see Part II.C. of Joint Committee on Taxation, *Present Law and Proposals Relating to Subchapter S Corporations and Home Office Deductions* (JCS–16–95), May 24, 1995.

Table 3.—Number of Different Types of Business Returns Relative to All Business Returns, 1978–1993

Year	1978	1979	1980	1981	1982	1983	1984	1985
Nonfarm sole proprietorships	8,908,289	9,343,603	9,730,019	9,584,790	10,105,515	10,703,921	11,262,390	11,928,573
C Corps	1,898,100	2,041,887	2,165,149	2,270,931	2,361,714	2,350,804	2,469,404	2,552,470
S Corps	478,679	514,907	545,389	541,489	564,219	648,267	701,339	724,749
Partnerships	1,234,157	1,299,593	1,379,654	1,460,502	1,514,212	1,541,539	1,643,581	1,713,603
Total	12,519,225	13,199,990	13,820,211	13,857,712	14,545,660	15,244,531	16,076,714	16,919,395
Percent of all businesses:								
Nonfarm sole proprietorships	71.2	70.8	70.4	69.2	69.5	70.2	70.1	70.5
C Corps	15.2	15.5	15.7	16.4	16.2	15.4	15.4	15.1
S Corps	3.8	3.9	3.9	3.9	3.9	4.3	4.4	4.3
Partnerships	9.9	9.8	10.0	10.5	10.4	10.1	10.2	10.1
Annual growth rate in number of returns (percent):								
Nonfarm sole proprietorships	.....	4.9	4.1	−1.5	5.4	5.9	5.2	5.9
C Corps	4.7	7.6	6.0	4.9	4.0	−0.5	5.0	3.4
S Corps	11.8	7.6	5.9	−0.7	4.2	14.9	8.2	3.3
Partnerships	7.0	5.3	6.2	5.9	3.7	1.8	6.6	4.3

Source: Internal Revenue Service, *Statistics of Income,* published and unpublished data.

Table 3.—Number of Different Types of Business Returns Relative to All Business Returns, 1978–1993-continued

Year	1986	1987	1988	1989	1990	1991	1992	1993
Nonfarm sole proprietorships	12,393,700	13,091,132	13,679,302	14,297,558	14,782,738	15,180,722	15,495,419	15,848,119
C Corps	2,602,301	2,484,228	2,305,598	2,204,896	2,141,558	2,105,200	2,083,652	2,063,124
S Corps	826,214	1,127,905	1,257,191	1,422,967	1,575,092	1,696,927	1,785,371	1,901,505
Partnerships	1,702,952	1,648,035	1,654,245	1,635,164	1,553,529	1,515,345	1,484,752	1,467,567
Total	17,525,167	18,351,300	18,896,336	19,560,585	20,052,917	20,498,194	20,849,194	21,280,315
Percent of all businesses:								
Nonfarm sole proprietorships	70.7	71.3	72.4	73.1	73.7	74.1	74.3	74.5
C Corps	14.8	13.5	12.2	11.3	10.7	10.3	10.0	9.7
S Corps	4.7	6.1	6.7	7.3	7.9	8.3	8.6	8.9
Partnerships	9.7	9.0	8.8	8.4	7.7	7.4	7.1	6.9
Annual growth rate in number of returns (percent):								
Nonfarm sole proprietorships	3.9	5.6	4.5	4.5	3.4	2.7	2.1	2.3
C Corps	2.0	−4.5	−7.2	−4.4	−2.9	−1.7	−1.0	−1.0
S Corps	14.0	36.5	11.5	13.2	10.7	7.7	5.2	6.5
Partnerships	−0.6	−3.2	0.4	−1.2	−5.0	−2.5	−2.0	−1.2

Source: Internal Revenue Service, *Statistics of Income,* published and unpublished data.

While one may often associate small businesses with organization in the form of a sole proprietorship, a partnership, or an S corporation, there is not an ironclad correspondence between the size of the business and the form of organization. While many small businesses are arranged as a sole proprietorship, a partnership, or an S corporation, not all businesses organized in those forms are small and not all businesses organized as C corporations are large. One can use SOI data on assets and gross receipts to measure the size of businesses in order to sort out how small businesses are arrayed across the different forms of organization.

Tables 4 through 7 display 1993 SOI data on C corporations, S corporations, partnerships, and nonfarm sole proprietorships. For the first three forms of organization, the tables classify all taxpayers using that form of organization both by the size of assets and gross receipts. For sole proprietorships, there is no tax data on assets, so the table uses only gross receipts as a classifier. When businesses are classified by asset size, one can see that there are a significant number of C corporations of small size. Almost 816,000 have assets under $50,000, nearly 40 percent of the total. For both S corporations and partnerships, slightly over one-half have assets under $50,000. The concentration of assets differs among the three forms. C corporations have the largest disparity in asset holding—firms with over $100 million in assets, which represent two-thirds of one percent of C corporations, hold over 90 percent of the assets in C corporations. By comparison, a similar share of partnership returns (those with assets over $50 million) holds just under one-half of the assets in partnerships[69] and a similar share of S corporation returns (those with assets over $10 million) hold about one-third of S corporation assets. Charts 4 through 6 graph the data from the tables. The area between the lines showing the cumulative number of returns and the cumulative amount of total assets gives an indication of the dispersion of assets across firms of different sizes. The greater the area, the greater the dispersion.

[69] Nearly a third of partnerships report assets less than or equal to zero, which is much higher than for either C corporations or S corporations. A partnership may have negative assets if, for example, it invests in a second partnership that is leveraged and has a minimal amount of assets. In such a case, the value of the second partnership is negative and equal in absolute value to the amount of debt in excess of the assets. This negative value shows up on the balance sheet of the first partnership as an asset with negative value. In 1993, there were 19,793 partnerships with assets less than zero. The total amount of negative assets held by these partnerships was $46.4 billion. In the tables in the text and in the appendix, these negative assets are disregarded in calculating the total assets held by partnerships and the cumulative shares of total assets held by the various asset classes.

Table 4.—Distribution of C Corporations, 1993

Firms classified by assets less than	All returns			
	Numbers of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	111,904	.....	5.42	.....
$25,000	479,095	$4,371	28.65	0.02
$50,000	224,963	8,122	39.55	0.06
$100,000	266,321	19,397	52.46	0.15
$250,000	352,469	57,171	69.54	0.43
$500,000	233,044	82,648	80.84	0.82
$1,000,000	161,340	113,859	88.66	1.36
$10,000,000	186,711	502,478	97.71	3.76
$50,000,000	26,881	607,653	99.01	6.66
$100,000,000	7,275	516,322	99.36	9.13
Over $100,000,000	13,121	19,033,550	100.00	100.00
Total	2,063,124	$20,945,570	.....	.....

Firms classified by gross receipts less than	All returns			
	Number of returns	Gross receipts (millions)	Cummulative Percent	
			Returns	Gross receipts
$0	253,079	.....	12.27	.....
$2,500	47,130	$53	14.55	0.00
$5,000	26,609	96	15.84	0.00
$10,000	49,368	361	18.23	0.01
$25,000	106,691	1,813	23.41	0.03
$50,000	125,773	4,670	29.50	0.08
$100,000	181,379	13,384	38.29	0.23
$250,000	329,867	55,152	54.28	0.85
$500,000	293,182	105,101	68.49	2.03
$1,000,000	247,057	176,297	80.47	4.01
$10,000,000	351,551	987,687	97.51	15.11
$50,000,000	39,757	805,464	99.43	24.16
Over $50,000,000	11,682	6,747,529	100.00	100.00
Total	2,063,124	$8,897,606	.....	.....

Source: JCT calculations from *Statistics of Income* data.

Table 5.—Distribution of S Corporations, 1993

Firms classified by assets less than	All returns			
	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	127,428	.....	6.70	.....
$25,000	598,917	$5,350	38.20	0.61
$50,000	237,537	8,580	50.69	1.60
$100,000	241,809	17,367	63.41	3.60
$250,000	282,800	45,493	78.28	8.82
$500,000	161,200	56,945	86.76	15.37
$1,000,000	107,937	76,098	92.43	24.11
$10,000,000	132,507	359,879	99.40	65.46
$50,000,000	10,381	193,771	99.95	87.73
$100,000,000	694	46,636	99.98	93.09
Over $100,000,000	295	60,180	100.00	100.00
Total	1,901,505	$870,299	.....	.....

Firms classified by gross receipts less than	All returns			
	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	300,406	.....	15.80	.....
$2,500	48,784	$56	18.36	0.00
$5,000	32,815	122	20.09	0.01
$10,000	51,408	376	22.79	0.03
$25,000	110,622	1,887	28.61	0.12
$50,000	120,124	4,402	34.93	0.35
$100,000	204,134	14,676	45.66	1.09
$250,000	333,978	55,233	63.23	3.90
$500,000	245,022	87,528	76.11	8.35
$1,000,000	188,280	133,669	86.01	15.14
$10,000,000	231,733	633,469	98.20	47.33
$50,000,000	30,213	607,085	99.79	78.18
Over $50,000,000	3,986	429,433	100.00	100.00
Total	1,901,505	$1,967,936	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table 6.—Distribution of Partnerships, 1993

Firms classified by assets less than	All returns			
	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	463,648	.....	31.59	.....
$25,000	186,147	$1,723	44.28	0.08
$50,000	87,541	3,286	50.24	0.23
$100,000	106,948	7,840	57.53	0.60
$250,000	180,385	29,342	69.82	1.96
$500,000	129,838	46,129	78.67	4.10
$1,000,000	112,470	79,830	86.33	7.80
$10,000,000	173,764	502,065	98.17	31.10
$50,000,000	21,633	435,752	99.65	51.32
$100,000,000	2,753	190,950	99.83	60.18
Over $100,000,000	2,439	858,194	100.00	100.00
Total	1,467,567	$2,155,112	.....	.....

Firms classified by gross receipts less than	All returns			
	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	905,377	.....	61.69	.....
$2,500	41,118	$42	64.49	0.01
$5,000	22,872	83	66.05	0.02
$10,000	29,656	212	68.07	0.06
$25,000	59,758	1,003	72.15	0.24
$50,000	62,939	2,321	76.43	0.64
$100,000	79,227	5,825	81.83	1.67
$250,000	108,622	17,551	89.23	4.76
$500,000	63,324	22,334	93.55	8.70
$1,000,000	41,975	29,689	96.41	13.92
$10,000,000	46,225	120,675	99.56	35.18
$50,000,000	5,148	106,629	99.91	53.96
Over $50,000,000	1,326	261,427	100.00	100.00
Total	1,467,567	$567,790	.....	.....

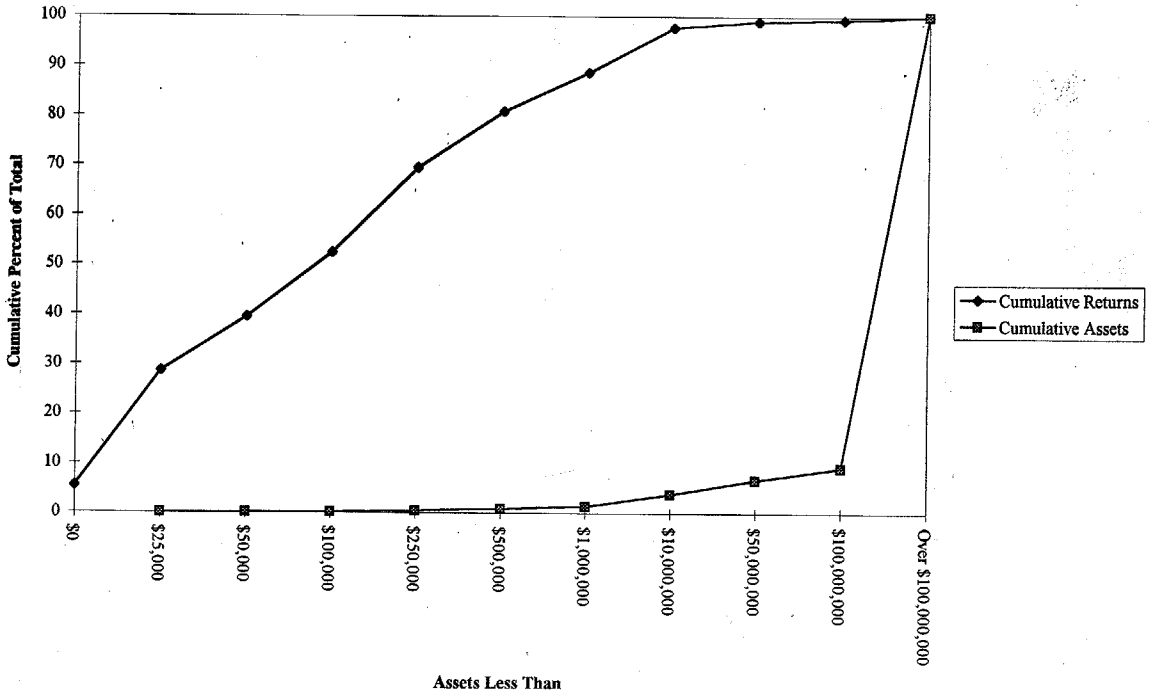
Source: JCT calculations from IRS *Statistics of Income* data.

Table 7.—Distribution of Nonfarm Sole Proprietorships, 1993

Firms classified by gross receipts less than	All returns			
	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	607,575	.....	3.83	.....
$2,500	3,771,760	$4,427	27.63	0.59
$5,000	1,772,152	6,377	38.81	1.44
$10,000	2,124,247	15,250	52.22	3.46
$25,000	2,829,930	45,880	70.07	9.56
$50,000	1,791,925	63,160	81.38	17.95
$100,000	1,313,600	92,340	89.67	30.21
$250,000	1,068,842	163,531	96.41	51.94
$500,000	364,308	124,304	98.71	68.45
$1,000,000	135,894	92,005	99.57	80.67
$10,000,000	67,904	126,222	100.00	97.44
$50,000,000	707	14,888	100.00	99.42
Over $50,000,000	38	4,366	100.00	100.00
Total	15,848,883	$752,751	.....	.....

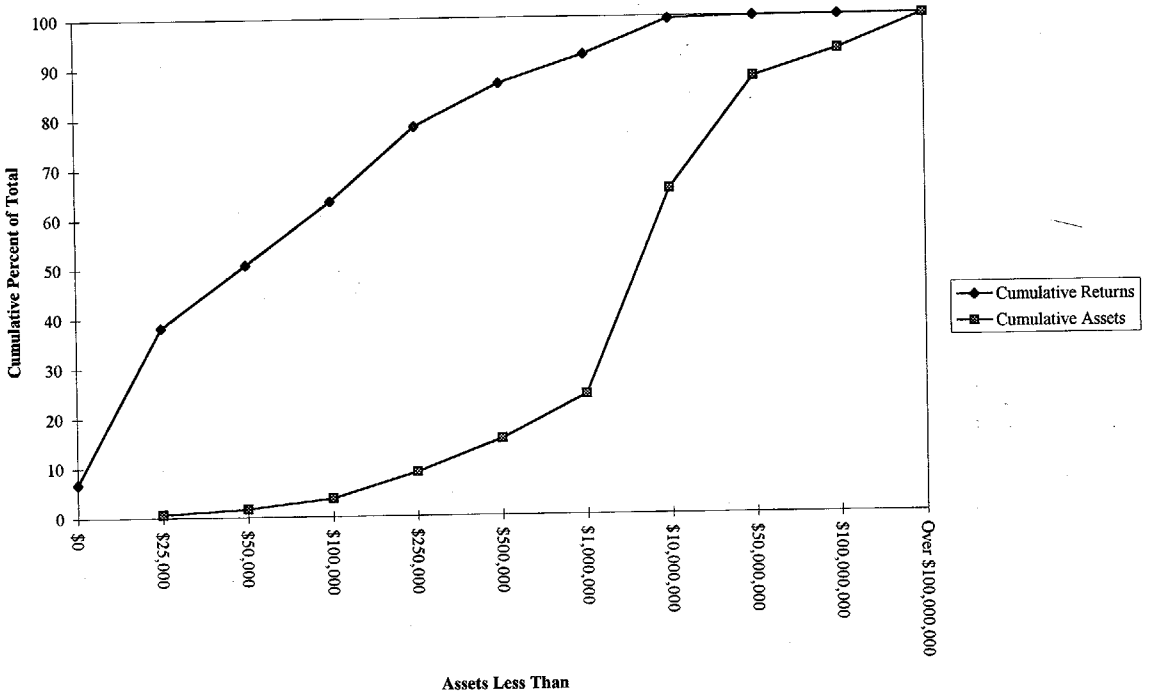
Source: JCT calculations from IRS *Statistics of Income* data.

Chart 4.-- C corporations (1993) -- All Returns



Source: JCT calculations from Statistics of Income data

Chart 5. -- S Corporations (1993) -- All Returns



Source: JCT calculations from Statistics of Income data

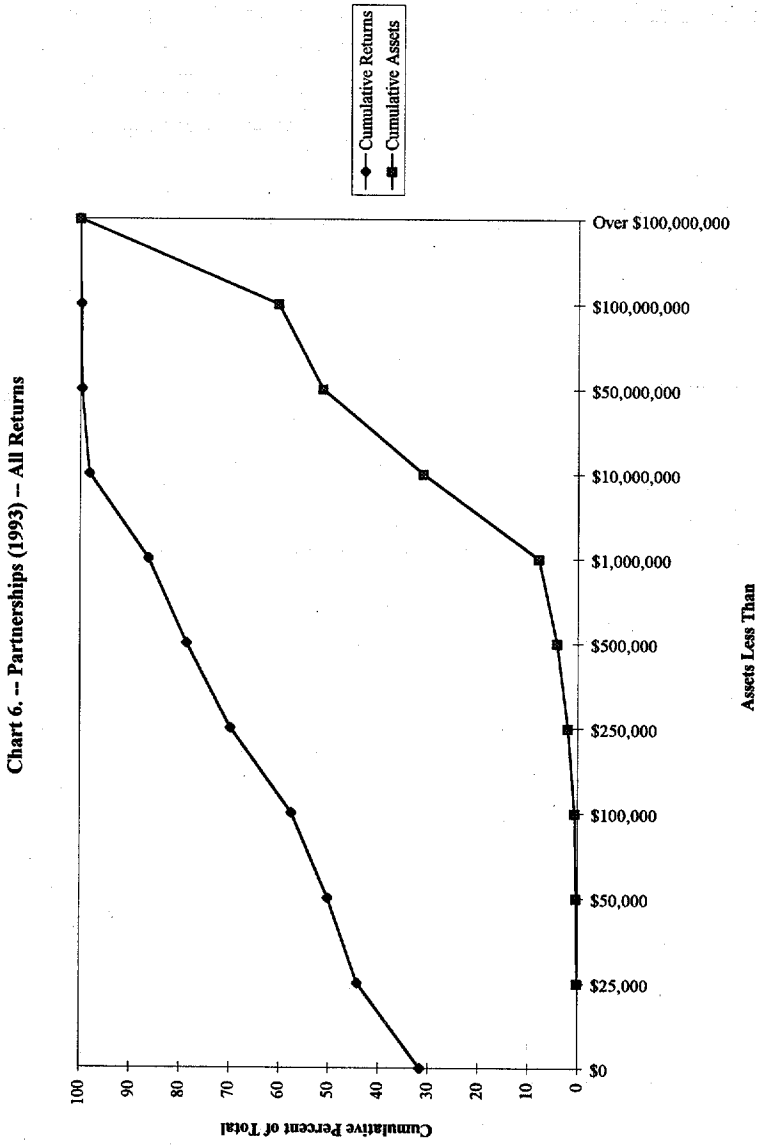
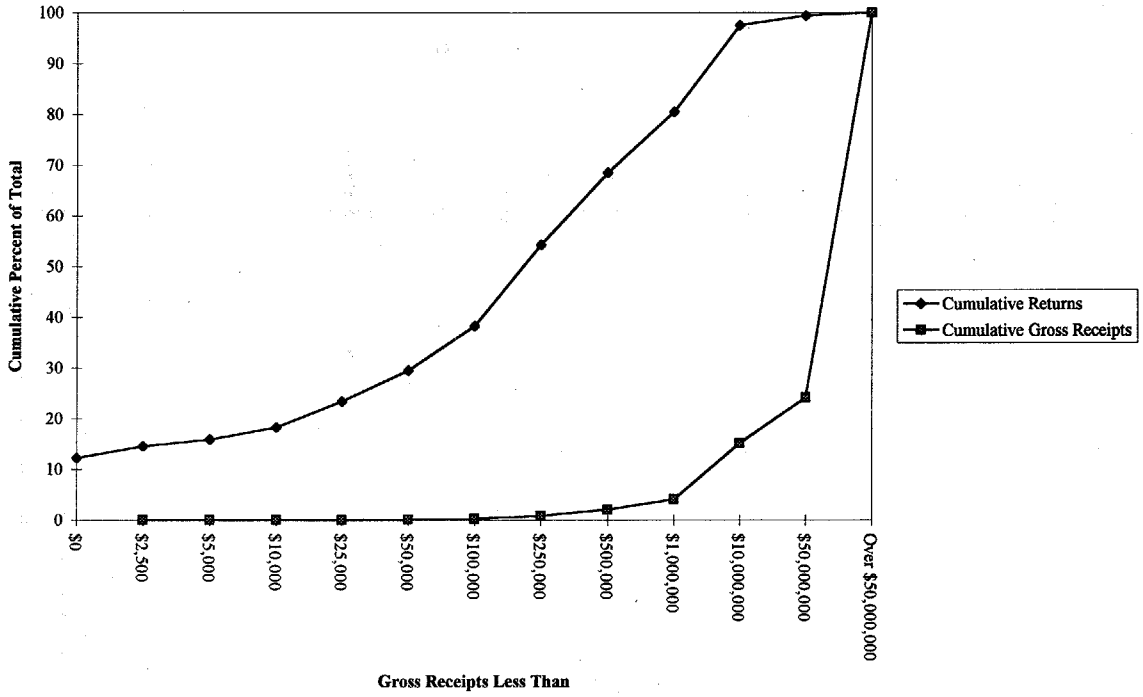


Chart 6. -- Partnerships (1993) -- All Returns

Source: JCT Calculations from Statistics of Income data

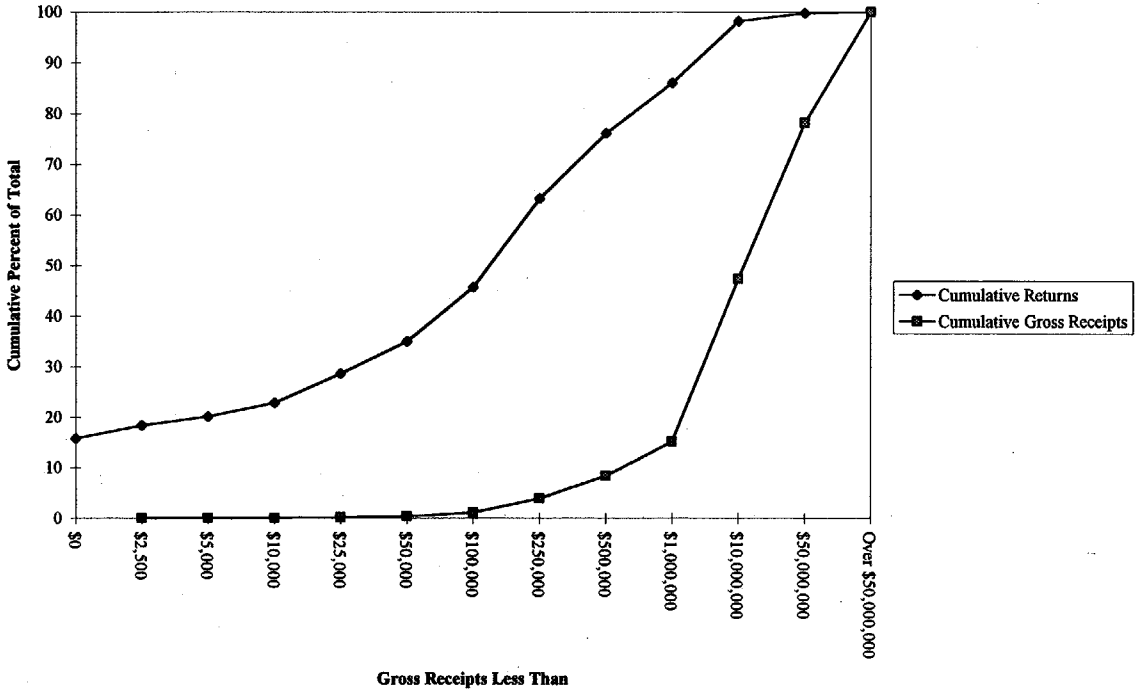
When businesses are classified by gross receipts, a picture emerges that is similar to that seen in the asset data. There are a substantial number of quite small C corporations (almost 483,000 with gross receipts less than $25,000—23 percent of the number of C corporations). But across the other forms of organization there are higher percentages of businesses with small amounts of gross receipts. For nonfarm sole proprietorships, 70 percent have gross receipts under $25,000, while for partnerships there are 72 percent and for S corporations there are 29 percent. Over three-fifths of partnerships report no gross receipts, while for nonfarm sole proprietorships, that fraction is under four percent. As with assets, the dispersion of gross receipts across the classifications is more skewed for C corporations and partnerships than for S corporations. Nonfarm sole proprietorships are similar to S corporations in this regard. C corporations with over $50 million in gross receipts, which represent just over one-half of one percent of C corporations, collect over three-quarters of gross receipts of C corporations. A similar share of partnership returns (those with over $10 million in gross receipts) collect almost 65 percent of gross receipts of partnerships. The comparable fraction of S corporation returns (those with gross receipts over $50 million) collect about one-quarter of S corporation gross receipts, while nonfarm sole proprietorships with gross receipts over $1 million collect only about one-fifth of nonfarm sole proprietorship gross receipts. Charts 7 through 9 graph the data from the tables.

Chart 7. -- C corporations (1993) -- All Returns



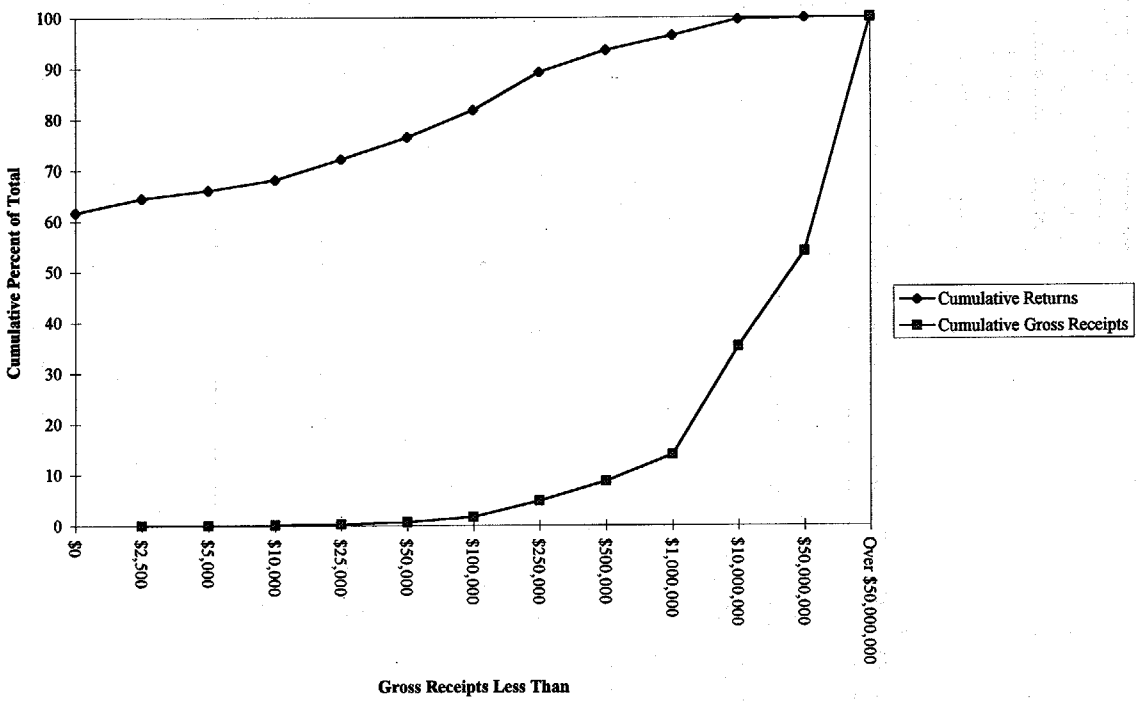
Source: JCT Calculations from Statistics of Income data

Chart 8. -- S Corporations (1993) -- All Returns



Source: JCT Calculations from Statistics of Income data

Chart 9. -- Partnerships (1993) -- All Returns



Source: JCT Calculations from Statistics of Income data

The appendix tables show the same information on assets and gross receipts for C corporations, S corporations, and partnerships when the businesses are grouped by their primary industrial categories. One can note that among C corporations and partnerships, there are relatively more small firms among the agriculture, construction, and services categories. For partnerships, manufacturing firms tend to be larger. For S corporations, the distribution of firms within different industrial categories is not much different from the distribution of S corporations as a whole.

An alternative way of characterizing business size is by the number of employees. Information about a firm's number of employees is not available from tax data, but it is available through data collected by the Small Business Administration ("SBA"). The SBA defines a firm as a small business if it employs fewer than 500 employees. Tables 8 and 9 below present data comparable to Tables 4 through 7 using data compiled by the SBA from surveys in 1991 by the Bureau of the Census. The SBA estimates that in 1991 there were approximately 5.1 million firms in the United States employing 92.3 million persons.[70] The SBA estimates that more than 99 percent of the firms are small businesses and that these small businesses employ 53 percent of the individuals employed in the private sector. Thus, oppositely, a relatively small number of businesses (the large businesses) employ a large percentage of the private sector workforce. This finding is consistent with the data reported in Tables 4 through 7 that show that a large percentage of assets are held (gross receipts are received) by a relatively small number of businesses characterized by a high level of gross assets (gross receipts).

The majority of small businesses and the majority of small business employment are in the wholesale or retail trade or services sectors. In 1991, these sectors accounted for 68 percent of the small businesses in the United States and 66 percent of the small business employment. Table 8 below presents the percentage distribution of small business firms and the percentage distribution of small business employment across various sectors of the United States's economy for 1991. Table 9 reports within each sector the percentage distribution of firms and employment distributed by firm size.

[70] The U.S. Small Business Administration, "The Annual Report on Small Business and Competition," in *The State of Small Business: A Report of the President, 1994*, p. 164. Note that the SBA data identify as firms only those businesses with at least one employee. Thus the figure of 5.1 million firms in 1991 is not directly comparable to the listing in Table 3 (20.5 million firms in 1991), which includes firms (especially sole proprietorships) that file tax returns but may have no employees.

Table 8.—Percentage Distribution of Small Business Firms and Employment by Sector, 1991

	Percent of all small business firms	Percent of all small business employees
Agriculture, forestry and fishing	1.8	1.0
Mining	0.5	0.6
Construction	11.5	8.4
Manufacturing	6.3	14.1
Transportation, communication and public utilities	3.6	3.9
Wholesale and retail trade	29.3	30.2
Finance, insurance, and real estate	8.1	6.0
Services	38.8	35.7
Other	0.6	0.1

Source: U.S. Small Business Administration, "The Annual Report on Small Business and Competition," in *The State of Small Business: A Report of the President, 1994,* Table A.4.

Table 9.—Percentage Distribution of Number of Firms and Employment by Size of Firm, 1991

Sector	Firms employing (percentage)—					
	<500	<20	<20–99	<100–499	Number of firms	500 or more
Agriculture, forestry, and fishing:						
# firms	99.9	95.3	4.1	0.4	0.1	91,743
#employees	89.5	56.9	23.7	8.8	10.5	545,156
Mining:						
# firms	98.3	83.3	12.2	2.8	1.7	24,285
#employees	41.1	12.4	15.3	13.4	58.9	716,425
Construction:						
# firms	99.9	92.5	6.7	6.8	0.1	582,344
#employees	87.6	43.7	30.4	13.5	12.4	4,680,166
Manufacturing:						
# firms	98.6	73.6	20.0	5.0	1.4	322,018
#employees	37.6	7.2	14.4	1.6	62.4	18,390,674
Transportation, communication and public utilities:						
# firms	99.1	86.7	10.5	1.9	0.9	181,524
#employees	34.4	11.7	13.0	9.7	65.6	5,590,526
Wholesale and retail trade:						
# firms	99.6	87.7	10.6	1.3	0.4	1,481,705
#employees	57.2	23.3	22.4	11.5	42.8	25,852,165
Finance, insurance and real estate:						
# firms	99.3	92.0	5.9	1.4	0.7	409,863
#employees	42.7	17.3	13.4	12.1	57.3	6,862,377
Services:						
# firms	99.6	91.1	7.1	1.4	0.4	1,962,388
#employees	59.1	23.7	18.2	17.2	40.9	29,623,508
Other:						
# firms	100.0	99.0	1.0	0.0	0.0	29,027
#employees	100.0	80.6	19.4	0.0	0.0	46,562

Source: U.S. Small Business Administration, "The Annual Report on Small Business and Competition," in *The State of Small Business: A Report of the President, 1994,* Table A–4.

2. Worker misclassification and compliance

IRS audits of employment tax returns declined from over 100,000 in 1979 to about 62,000 in 1994.[71] This represented a decrease in audit coverage from approximately one-half of one percent to approximately two-tenths of one percent of employment tax returns filed.

The IRS survey of 1984 employment tax returns found that nearly 15 percent of employers misclassified employees as independent contractors.[72] According to the IRS, the section 530 safe harbor protected 2 two percent of misclassified employees from being reclassified as employees. Of those returns using the section 530 safe harbor protections, nearly half relied on the prior audit provision. The General Accounting Office ("GAO") has reported that from 1988 through 1994 the IRS completed 11,380 employment tax audits. These audits resulted in proposed tax assessments of $751 million and reclassification of 483,000 workers as employees.[73]

The IRS survey also found that when employers classified workers as employees, more than 99 percent of wage and salary income was reported. However, when workers were misclassified as independent contractors, 77 percent of income was reported when a Form 1099 was filed, and only 29 percent of income was reported when no Form 1099 was filed.

[71] Internal Revenue Service, "1993–1994 Data Book."

[72] Internal Revenue Service, "Strategic Initiative on Withholding Noncompliance (SVC–1) Employer Survey Report of Findings," June 1989.

[73] General Accounting Office, "Tax Administration Issues Involving Worker Classification," Statement of Natwar M. Gandhi, Associate Director, Tax Policy and Administration Issues, General Government Division, August 2, 1995 (GAO/T–GGD–95–224).

D. Analysis of Impact on Small Businesses

1. Choice of entity and capital structure considerations

Overview

Under present law,[74] the choice of entity to conduct business activities affects the tax treatment of the entity as well as its investors. Some entities ("pass-through" entities) involve one level of tax at the owner level. Other entities ("C" corporations) involve tax at the entity and the owner level. Proposals to reduce or eliminate this dual-level tax are often referred to as corporate integration proposals; that is, proposals to integrate the corporate and investor level tax to produce at most one level of tax.[75]

The tax treatment of the entity and its investors can interact with the choice of capital structure (e.g., whether to raise funds as debt or equity), because debt and equity investments have different tax results for different types of entities and different investors in those entities. The form of an instrument is not necessarily controlling in determining whether an instrument will be respected for tax purposes as debt or equity; but taxpayers have considerable latitude in structuring the terms of an instrument to obtain the desired treatment.

The tax treatment of an entity can also create incentives in structuring the business operations or characterization of payments to shareholders. For example, in the case of a C corporation, dividends are not deductible, but payments to shareholders who engage in certain transactions with the entity (e.g., providing services for compensation, or leasing property for rents) may be deductible if not in excess of reasonable payments.

Present law provides certain limited incentives to investors in small business, such as special treatment of certain capital gains, favorable treatment of certain losses, and opportunities for certain tax-exempt bond financing.

Consumption tax

Under the various consumption tax proposals, businesses are subject to tax in the same manner regardless of form. Thus, considerations of choice of entity are potentially eliminated. Similarly, debt and equity investments are treated in the same manner under the particular proposals presented, as are dividends and capital gains; thus considerations of capital structure are also reduced or eliminated. The various consumption tax proposals thus achieve a form of "corporate integration."

Wages may be taxed at the individual level, while returns on debt or equity are not. However, this does not create an incentive to structure cash withdrawals from the business by owner-employees as dividends rather than wages so long as the business is permitted to deduct wages but not dividends and the tax rates on the business and the individual are the same. Even if the business is not permitted to deduct wages so long as wages are treated in the

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[74] For a more comprehensive discussion of present law, see "Choice of entity and capital structure considerations" under Part II, A., "Present Law and Background," *supra*.

[75] See, e.g., Department of the Treasury, *Integration of the Individual and Corporate Tax Systems*, January 1992.

same manner as other payments, both to the business and to the recipient, there is no special incentive to structure payments as wages, dividends, interest, or other particular items.

Similarly, rents may be taxed to the recipient and deducted by the payor, while interest may be excluded by the recipient and not deducted by the payor. Again, so long as the tax rates on the payor and the recipient are the same, there should not be an incentive to restructure interest as rent or vice versa.

To the extent there are significant variations in the tax rates of a payor and a payee, (through various rate brackets or through significant exemptions or exempt entities) different treatments of rents and interest (or of wages dividends, or other payments) could still provide an incentive to restructure or recharacterize amounts to reduce the total tax payable.

"Pure" income tax

How the choice of entity and capital structure considerations under present law would be affected by a change to a "pure" income tax would depend upon the structure of such a tax. For example, in theory such a tax might contain elements of "corporate integration" that would reduce the disparity in tax treatment of different entities. Reducing the disparities in tax effects of debt, equity, and other payments also might be part of such a tax. As in the case of consumption taxes, to the extent there are significant variations in the tax rates of a payor and a payee (whether as a result of various rate brackets or through significant exemptions or the presence of exempt entities that are not taxed), there still may be incentives to restructure or recharacterize amounts in order to reduce the total tax payable.

Certain aspects suggested for such a tax, if implemented separately, could have more particular effects. If "mark-to-market" aspects of such a tax were adopted, the ability to defer tax (or obtain a basis-step-up at death, eliminating income tax) would be restricted. At the same time, if the approach were also applied to losses, present-law disparities between treatment of capital and ordinary losses might be reduced. Any such approach would be subject to administrative considerations—for example, issues of valuing property that is not publicly traded.

A "pure" income tax might eliminate preferential rates for capital gains as compared with dividend income on the theory that all income should be taxed in as nearly similar a manner as possible. This might reduce some incentives under present law for a C corporation to retain earnings or to distribute them in the form of share repurchases rather than dividends. Some shareholders with significant basis in their stock and who are not eligible for any dividends received deduction might still prefer capital gains to dividends because of the ability to recover basis before tax is imposed on a capital gains distribution.

Special rules benefitting small business investors

Both a consumption tax and a "pure" income tax would eliminate the special benefits afforded to certain small business investors under present law. The consumption tax would do this by affording equal tax-exempt treatment to returns and losses on all invest-

ments. The "pure" income tax would do this by taxing all returns (and losses) on all investments in the same manner. Thus, any relative advantage these particular present law provisions may offer to small business would be eliminated under either approach.

2. Expensing of capital costs

Overview

The expensing provision of section 179 of present law generally is considered to be a tax benefit provided to small businesses.[76] Specifically, the present-law section 179 expensing allowance provides an incentive for small businesses to invest in tangible personal property. However, any tax incentive may have unintended effects. For example, it may: (1) reward investments that may have occurred in any event; (2) encourage "churning" by selling off nonqualified property and using the proceeds to acquire qualified property, without a resulting increase in net investment; or (3) be overutilized and result in an over-investment in targeted property, to the detriment of investment in other productive property. The provision of tax benefits to influence behavior generally is effective only if the benefits can be used by the targeted taxpayers. The effectiveness of present-law section 179 may be limited. Expensing is not available if the taxpayer makes a large investment (over $200,000) in qualified equipment during the year. Thus, a relatively "small" competitor in a capital-intensive business (e.g., a steel fabricator that specializes in certain products) may not qualify for section 179 expensing, while a large competitor in a service business (e.g., a national law firm) may qualify. In addition, the taxable income limitation may cause section 179 expensing to be worthless to a business that is in the start-up stage and not generating taxable income. In fact, the limitations of present-law section 179 may operate to delay investment in qualified property over a period of years so as to maximize annual expensing allowances over the investment period.[77]

In addition, an expensing allowance provides the greatest incentive for those taxpayers who are subject to the highest marginal income tax rate. It is unclear whether the extent to which small businesses are within such group.

For these reasons, some believe that incentives to influence behavior are better accomplished through direct expenditures than through the Internal Revenue Code.

The present-law section 179 expensing allowance also is viewed as a simplification measure for small businesses because annual depreciation calculations and records become unnecessary for expensed property. However, this simplification goal is fully achieved only if the amount of the taxpayer's qualified investment for the

[76] Section 179 was enacted as part of the Technical Amendments Act of 1958, which added other tax provisions targeting toward benefitting small businesses, including treating losses on certain small business stock as ordinary rather than capital losses; extending the carryover period for net operating losses; instituting subchapter S; increasing the minimum accumulated earnings credit (since repealed); and providing an extension of time from payment of estate tax attributable to investments in closely held enterprises.

[77] For example, assume that a taxpayer wishes to invest in $400,000 of qualified property. If the taxpayer makes the entire investment in Year 1, no expensing is allowed under section 179 because of the $200,000 phase-out. However, if the taxpayer evenly spreads the investment over Years 1 and 2, full expensing is allowed for both years, subject to the income limitation.

taxable year does not exceed the $17,500 limitation. Otherwise, the taxpayer must identify, and properly account for, property to which the expensing allowance applies and property to which it does not.

Expensing under consumption taxes

Those consumption taxes that provide a business-level tax on all businesses (i.e, VATs and those taxes such as the consumption-based flat tax and the USA Tax that have VATs as a component) allow expensing for the cost of all property and services acquired by the taxpayer. Thus, these taxes expand present-law section 179 to include all types of investment without limitation. Unlike present law, such treatment is provided in order to create a consumption base for the applicable tax, rather than to provide tax incentives or administrative simplification under an income tax. As discussed above, the difference between an income tax and a consumption tax is that under the former, returns to savings are subject to tax; under a consumption tax, returns to saving are not taxed. Investment by a business in income-producing property, such as machinery and equipment, is a form of saving. Consumption tax treatment could be provided to such investment by providing a tax exemption for the income generated by the investment. Providing such an exemption may be feasible with respect to investments that generate an identifiable stream of income, such as interest income with respect to a bond. However, it is administratively difficult to determine the stream of income allocable to the capital investment in machinery and equipment because income from a manufacturing or similar process is attributable to not only investment in capital, but the use of labor and entrepreneurial skills as well. Alternatively, one could exempt capital income by providing an expensing deduction for the cost of the property in the year the investment is made. Expensing is equivalent to tax exemption because the cost of property is equal to the present value of the stream of income expected to be generated by the property.

Thus, enactment of a consumption tax generally would provide expensing to all investments of all businesses and would eliminate the relative competitive advantage small businesses enjoy under section 179 of present law.

Expensing under a "pure" income tax

One of the goals of a "pure" income tax is to properly measure economic income so as not to distort investment decisions. In order to more properly measure economic income, the cost of property that has a useful life longer than one year should be recovered over such useful life. The election to expense the cost of long-lived property under section 179 of present law is a departure from this goal. Thus, the section 179 expensing allowance would be repealed under a "pure" income tax. Such repeal would increase the compliance burdens of small businesses that would have to maintain depreciation records for their investments in tangible personal property.

3. Tax accounting methods

Overview

Small businesses generally are provided exceptions from normative tax accounting rules in order to alleviate their record-keeping burdens. In most instances, these simplified methods also reduce the tax liability of the qualified small business. Thus, the simplified methods of present law serve the dual purpose of easing the administrative burdens of, and providing a tax subsidy to, small businesses.

Tax accounting methods under consumption taxes

The perceived difficulty of some of the tax accounting methods from which small businesses are granted exceptions are a result of the need to measure income under the present-law income tax. These methods generally attempt to match income and expense by requiring capitalization of costs that benefit future periods and providing when and how these capitalized costs are taken into account. As discussed above, the enactment of a consumption tax generally would provide expensing for all business expenditures and would repeal the capitalization and inventory accounting rules of present law.

Fewer tax accounting rules are needed under a consumption tax. For example, rules regarding capitalization, inventory flows, depreciation, and other cost recovery would no longer be required. Rules would be needed in order to determine the proper period when items of gross income and expense should be taken into account. Essentially, these rules would require taxpayers to be placed on either an accrual or cash method. Indeed, some of the consumption taxes introduced to date provide for a choice of overall accounting methods.[78]

In addition, because consumption taxes generally do not allow deductions for interest expense or subject interest income to tax, rules may be needed to distinguish disguised interest in the case of prepayments and deferred payments. As an example, assume that an individual consumer acquires a used automobile from a dealer who offers to finance the transaction. Under the financing arrangement, the consumer is to pay the dealer $1,000 a year for five years. Further assume that a consumption tax applies to the transaction such that the dealer is subject to tax on the principal, but not the interest, portions of the installment payments. In this case, the dealer would have an incentive to characterize a significant portion of each $1,000 payment as tax-exempt interest rather than taxable principal. The consumer would be indifferent to the characterization because he or she can deduct neither principal nor interest.[79] Rules designed to address disguised interest may entail complexity at least equal to that of the current income tax. For example, under present law, Code sections 1271 through 1288 at-

[78] The USA Tax (S. 722) generally requires the use of an accrual method of accounting, but allows the use of the cash method: (1) where the taxpayer is currently using such method or (2) where allowed by the Secretary of the Treasury. The National Retail Sales Tax (H.R. 3039) allows taxpayers to choose between the cash and an accrual method.

[79] The issues presented by prepayments and deferred payments are less significant if both parties to a transaction are subject to the same tax rate and use the same accounting methods. In such instances, possibility of "tax arbitrage" is diminished or extinguished.

tempt to characterize, and provide proper treatment for, discount on debt obligations as interest. These rules have been criticized as among the most complex in the Code.

As another example, property can be transferred from one taxpayer to another in a transaction under which the user of the property pays for such use over time. These transactions can be characterized as leases or as installment sales, depending on the terms and substance of the underlying transactions. Under present law, characterization as a lease results in different tax treatment than does characterization as an installment sale. Specifically, if the transactions is treated as a sale, the provider of the property generally recognizes gain on the date of sale and includes interest income over the term of payments; the user of the property depreciates the cost of the property over its recovery period and claims interest expense over the term of the payments. If the transaction is treated as a lease, the provider of the property generally includes the payments in income as received and claims depreciation deductions for the cost of the property; the user of the property deducts its payments as rent over the lease term. As a result of these potentially differing treatments, the proper characterization of these and similar transactions is often the subject of controversy between taxpayers and the IRS under current law. Similarly, under the proposed consumption taxes, leases and installment sales may provide different tax treatments to both users and providers of property. Specifically, if the transaction is treated as a sale, the provider of the property generally includes in income the principal, but not the interest portion of the payments; user of the property expenses the cost of the property when acquired. If the transaction is treated as a lease, the provider of the property generally expenses the cost of the property and includes the payments in income as received; the user of the property deducts its payments as rent over the lease term. Because of these potentially differing tax treatments, unless the new tax system provides clear rules to characterize these transactions, disputes similar to those of present law may arise.

The substitution of new, potentially complex tax accounting rules in a consumption tax for old, potentially complex tax accounting rules under the income tax may not ease the compliance burden of taxpayers. In such case, consideration should be given to providing simplifying rules for small businesses. In any event, the enactment of any new tax system, no matter how simple, brings with it a degree of complexity for those accustomed to the old system.[80]

Tax accounting methods under a "pure" income tax

One of the goals of a "pure" income tax is to properly measure economic income so as not to distort investment decisions. Present law provides various tax accounting rules that attempt to reach this income measurement. Many of these provision were enacted as parts of the Tax Reform Act of 1986, which broadened the income tax base and lowered income tax rates. Small businesses often are exempted from these rules in order to lessen their administrative burdens and provide the businesses with a tax benefit. To the ex-

[80] The compliance aspects of taxpayers, including small businesses, under present law and alternative tax systems will be analyzed with respect to a planned future hearing on tax restructuring proposals.

tent a "pure" income tax further expands the tax base, consideration should be given as to whether the small business exemptions primarily provide administrative convenience (and hence should be retained) or provide tax benefits (and hence should be repealed).

4. Worker classification

Overview

One of the most significant issues that arises with respect to misclassification of workers is the effect on Federal budget receipts. Revenue loss can occur when workers are misclassified as self employed if such workers are treated more favorably for tax purposes than are employees. Another possible source of revenue loss is if there are lower compliance rates with respect to self-employed individuals and service recipients compared to the compliance rates of employees and their employers. These issues arise under present law, and may also arise under various proposals to restructure the Federal income tax.

Another issue that arises with respect to misclassification of workers is the penalties imposed for misclassification. Many businesses argue that the present-law penalties for misclassification are too severe, particularly in cases in which the misclassification was inadvertent.

Consumption tax proposals

Treatment under the Federal tax system

To the extent that there are more favorable tax rules with respect to self-employed individuals than there are with respect to employees, there will be an incentive for workers to be classified as self employed rather than employees. This incentive exists to some extent under present law because, in some cases, self-employed individuals receive more favorable tax treatment than employees. However, under present law, in some cases (e.g., the ability to exclude certain types of employee benefits from gross income), employees are treated more favorably than self-employed individuals. Thus, any revenue loss resulting from the more favorable treatment for self-employed individuals may be at least partially offset by other factors associated with self-employed status. The extent to which the incentive to classify workers as self employed and any associated revenue loss is greater or less under the restructuring proposals than under present law depends in part on whether the differences in treatment between self-employed individuals and employees are greater or less than under present law.[81]

In general, the USA Tax and the consumption-based flat taxes treat self-employed individuals in a similar manner. Such individuals are treated as businesses, and the income derived from the services provided by the individual is taxed as business income. The compensation the individual pays himself or herself is subject to tax as wages under the individual tax component of the proposals.[82] As under present law, self-employed individuals are entitled

[81] The restructuring proposals discussed here generally do not revise the present-law definition of employee.

[82] Under the Armey flat tax, individuals have an incentive to pay themselves compensation at least equal to the standard deduction.

to deductions for business expenses that employees are not entitled to take. This difference may be even greater under the proposals than under present law. Under present law, employees who itemize have some ability to deduct miscellaneous business expenses, whereas under the proposals no deduction for employee business expenses would be allowed.

Other aspects of the proposals may tend to reduce the disparity of treatment of employees and self-employed individuals. For example, under the proposals, employer-provided employee benefits, such as health benefits and dependent care benefits are generally not deductible by the employer.[83]

From the perspective of a business organization hiring a worker, there is one significant feature of the business component of the USA Tax that may provide an incentive for the business to classify a worker as self employed rather than as an employee and may raise compliance concerns. Under the USA Tax, businesses generally can deduct payments to independent contractors and other self-employed individuals, but cannot deduct wages. As described above, a worker classified as an independent contractor would be required to file a business return. Failures by independent contractors to file returns would result in an undercollection of overall tax.

Under the national sales tax or a VAT, individuals may prefer to be employees because they will not be required to file returns. On the other hand, an individual that operates a business as an independent contractor would generally be subject to administrative requirements associated with collecting the taxes.

Compliance

It is clear that under present law there is revenue loss associated with lower compliance rates of independent contractors and service recipients compared to the compliance rates of employees and their employers. Tax data indicate that service recipients often fail to file requisite Forms 1099 for payments made to independent contractors, and that independent contractors often fail to report the unreported payments as income. In addition, employers must file information reports on all wages paid to employees; the requirement with respect to service recipients are not as comprehensive. Even when Forms 1099 are issued, compliance is less than when workers are classified as employees and withholding is required. Noncompliance under alternatives to the current tax system might be expected to be similar to noncompliance under present law.

Penalties for misclassification

Despite the limits under present law on the amount of penalties that can be imposed for misclassification of workers as self employed, many businesses argue that the present-law penalties are excessive, particularly given that misclassification is often inadvertent. At the extremes, it will be clear whether a worker is properly characterized as an employee or independent contractor. However, many work situations will involve the grey area in between—some of the 20 factors may support employee status, while some in-

[83] The pension and employee benefit issues raised by proposals to restructure the Federal income tax will be addressed in detail in a subsequent staff pamphlet.

dicate independent contractor status. Because the determination of proper classification is factual, reasonable people may differ as to the correct result given a certain set of facts. Thus, even though a taxpayer in good faith determines that a worker is an independent contractor, an IRS agent may reach a different conclusion by, for example, weighing some of the 20 factors differently than the taxpayer. Taxpayers wishing certainty can obtain private letter rulings regarding the status of workers. However, not all taxpayers may wish to undertake the expense of obtaining a ruling or may not be able to wait for a ruling from the IRS. Thus, the prohibition on issuance of general guidance by the IRS may make the likelihood of such errors greater; the IRS is not permitted to publish guidance stating which factors are more relevant than others. In the absence of such guidance, not only may taxpayers and the IRS differ, but different IRS agents may also reach different conclusions, resulting in inconsistent enforcement.

One way to address any perceived unfairness in the present-law penalty structure would be to modify the rules relating to the definition of employee to provide more clarity for employers. The proposals to restructure the Federal tax Code generally do not address this issue, but a number of other legislative proposals have been introduced that would modify the definition of employee and provide more certainly to businesses and workers.

The extent to which effective penalties for misclassification of workers are needed depends in part on the resolution of the issues discussed above. That is, if there is little incentive to classify workers as self employed for tax purposes, and there are effective compliance measures to ensure that the proper amount of tax is collected from such individuals, then there may be less need for strict penalties for noncompliance.

"Pure" income tax

In general

The issues raised under a pure income tax are similar to those raised under present law and other Federal tax restructuring proposals.

Treatment under the Code

Under a pure income tax, many of the disparities between the treatment of employees and self-employed individuals would be reduced, reducing the incentive to misclassify workers. For example, under a pure income tax, all employee benefits generally would be includible in income both for employees and for self-employed individuals. Depending on the details of the proposal, the difference in ability to deduct business-related expenses might be reduced. However, some limits on the ability of employees to deduct business-related expenses might be desirable from a compliance standpoint. (See below for a further discussion of this issue.)

Compliance

Compliance issues generally would be expected to be similar under a pure income tax as under present law and other Federal

tax restructuring proposals, unless specific provisions are adopted to encourage greater compliance. (See above for further discussion.)

Penalties

Issues with respect to penalties are similar to issues under present law and other Federal tax restructuring proposals. (See above for further discussion.)

5. Dual use property

Overview

Dual use property creates issues under present law because property used for business purposes is entitled to favorable treatment not available with respect to property used for personal purposes. While theoretically it is possible to separate business use from personal use, in practice it may be difficult. If personal use is not properly separated from business use, then Federal budget receipts can be affected because taxpayers may claim deductions with respect to property that is not in fact used for business purposes. Under present law, concerns about properly identifying and treating business use have led to special rules applicable to property that is likely to be or is actually used predominantly for personal purposes. In this area, concerns for fairness and accuracy must often be balanced against concerns about undue burdens on taxpayers and government intrusiveness. Similar issues arise under proposed alternatives to the current Federal income tax (including both consumption and income tax alternatives).

Consumption taxes

It is necessary to separate business use of property from personal use under the various proposed consumption taxes, because property used for business purposes receives favorable tax treatment not available with respect to personal property. For example, under the consumption-based flat taxes and the business component of the USA Tax, the cost of business property is deductible in the year of purchase. Similarly, property purchased for resale or purchased to produce taxable property or service would not be subject to a national sales tax. If an individual uses property, e.g., a car or a home, both for personal and business purposes, then only the portion of the cost attributable to the business use should be deductible (or excludable from the tax base, in the case of the national sales tax).

Issues also arise with respect to property that is converted from one type of use to another. For example, suppose an individual purchases a car that is used exclusively for business purposes. Further suppose that, three years later, the individual stops using the car for business purposes and then sells the car. Under the consumption-based flat taxes, the entire cost of the car would be deductible in the year of purchase. Proceeds from the sale of personal property is not treated as income, and thus the sale would not be a taxable event. If, however, the individual had sold the car as a business asset, the proceeds would be includible in business income. To prevent avoidance of the business tax in this manner, the "conversion" of business use property to personal property could be treated as

a sale or exchange of the property by the business. Such treatment is provided under other consumption taxes.

The issues raised with respect to dual use property under consumption tax proposals are similar to the issues raised under present law. Under the alternatives, there may be slightly more incentive for taxpayers to try to treat property as business property because of the availability of immediate expensing, rather than depreciation deductions. As under present law, limiting special tax treatment to property actually used for business purposes is necessary to prevent an inappropriate reduction in Federal receipts. Also as under present law, while in theory it is possible to distinguish between business use and personal use, it may be difficult to do so in practice, both for taxpayers and tax enforcement authorities. Thus, as under present law, it may be appropriate to develop specific rules relating to types of property commonly used for dual purposes.

"Pure" income tax

Under a pure income tax, taxpayers would be entitled to deduct ordinary and necessary business expenses, including the expenses related to dual-use property, to the extent the property is actually used for business purposes. Distinguishing between personal and business uses raises issues similar to those under present law, and, as under present law, it may be appropriate to have specific rules relating to types of property commonly used for dual purposes.

III. START-UP AND RESEARCH COMPANIES

A. Present Law and Background

1. Start-up expenditures and organizational expenditures

Start-up expenditures

Taxpayers may elect to amortize start-up expenditures over a period of 60 months (sec. 195). Unless this election is made, such expenditures are not deductible but must be capitalized and recovered only upon disposition or abandonment of the business.

Start-up expenditures are any amounts paid or incurred, that would have been currently deductible if paid or incurred in connection with the operation of an existing business, but which instead are incurred in connection with investigating the creation or acquisition of an active business, or creating the trade or business. They also include amounts paid or incurred in connection with any activity engaged in for profit and for the production of income, before the day on which the active trade or business begins, in anticipation of such activity becoming a trade or business.

Disputes may arise under present law as to when the active conduct of the trade or business begins, such that expenditures no longer need to be capitalized.[84] Similarly, disputes may arise regarding whether an activity involves the creation or acquisition of a new trade or business, or merely the expansion of an existing one. In the latter case, expenditures may not be subject to the start-up expense capitalization rules.[85]

Organizational expenditures

A corporation or partnership may elect to amortize organizational expenditures over a 60-month period, beginning with the month in which the corporation or partnership begins business (secs. 248 and 709(b)(1)). If an election is not made, organizational expenditures must be capitalized and are recovered only on the disposition or abandonment of the enterprise.

Organizational expenditures can include, for example, legal services incident to the organization of the entity such as drafting the

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[84] See, e.g., *Bennett Paper Corp. & Subs v. Commissioner*, 699 F.2d 450 (8th Cir. 1983), aff'g 78 T.C. 458 (1982) (pre-opening expenses of a newly formed corporation in a consolidated group were not deductible when paid before carrying on business. The fact that a previously owned subsidiary in the same group had previously engaged in a similar business was not determinative); *Playboy Clubs Int'l, Inc. v. U.S.*, 76–2 USTC par. 9650 (N.D. Ill., 1976), aff'd in part, vacated in part and remanded in part, in unpub. opin. (7th Cir. May 16, 1977) (expenses incurred by newly formed subsidiary clubs in consolidated group before they opened were deductible since the subsidiaries engaged in the same business as the parent; their members enjoyed reciprocal privileges with other clubs in the consolidated group immediately, and the group reported the membership income of the new subsidiaries in its consolidated income); *Richmond Television Corp v. United States*, 345 F.2d 901 (4th Cir. 1965), vacated and remanded on other issues 382 U.S. 68 (1965) (taxpayer not entitled to deduct expenses until business begins to function as a going concern, notwithstanding expenditures over a considerable period to enter the business).

[85] Compare, e.g., *North Carolina Nat'l Bank v. United States* , 684 F.2d 285 (4th Cir. 1982), aff'g 78–2 USTC par. 9661 (W.D.N.C. 1978, vac'g 651 F.2d 942 (4th Cir. 1981) (expenses of applications for permission to open new branches and certain other exploratory expenses were currently deductible by a bank carrying on a trade or business); *Central Texas Savings & Loan Ass'n v. United States.*, 731 F.2d 1181 (5th Cir. 1984) (expenditures for market research and obtaining permits for new branches were costs of creating a new asset and were not deductible); *Cleveland Electric Illuminating Company v. United States*, 85–1 USTC Par. 9128 (7 Cls. Ct. 2)(training and advertising expenses related to new nuclear power plant were not currently deductible; they related to a new enterprise separate from the conventional coal-fueled power plant).

charter or partnership agreements; costs of necessary meetings; and fees paid for other expenses of organization. They do not include expenditures for issuing or selling stock or partnership interests. Such expenditures for raising equity capital are not deductible.

2. Net operating losses

Net operating losses ("NOLs") are computed for a taxable year as the excess of allowable deductions over gross income for that year, with certain modifications. NOLs generally may be carried back to the prior three taxable years and carried forward for the fifteen taxable years succeeding the loss year (sec. 172). A taxpayer may elect not to carry back NOLs, instead only using the carryforward period. Carrying the NOLs back against prior taxable income allows the benefit of the loss to be recognized in the current year by obtaining a refund of prior taxes paid.[86]

There is a special limitation on the carryback of corporate NOLs attributable to interest deductions attributable to certain "corporate equity reduction transactions," including certain major stock acquisitions and certain excess distributions (sec. 172(h)(3)). Such losses, however, may be carried forward.

The carryforward of losses is subject to special limitations if a business experiences an "ownership change" (sec. 382). In general, an ownership change occurs if more than 50 percent of the interests of 5 percent or greater shareholders are acquired by other such shareholders within a three-year period. Certain preferred stock interests are not counted for this purpose. If an ownership change occurs, loss carryforwards from before the change are limited in the amount that can be used in any subsequent period. The limitation generally is the value of the ownership interests in the business at the time of the ownership change, multiplied by a long-term tax-exempt interest rate. The amount of losses subject to limitation is increased by the amount of any net "built-in" losses that are attributable to periods before the ownership change and are recognized after the change date. The purpose of the limitation generally is to reduce incentives for acquiring or investing in a business at a price in excess of the value of its assets, that reflects the ability of the new owners to shelter their anticipated future income with losses of the business that arose before their ownership, which potentially may involve new business opportunities or capital unavailable to the old owners.[87] In some situations, these limitations could affect companies that incurred significant tax losses in early years and subsequently obtain new capital for stock sufficient to cause an ownership change.

Loss companies generally may not use their losses to offset certain built-in gains of an acquired corporations that had a net unrecognized built-in gain when acquired, if the gains are recognized within five years after the acquisition (sec. 384). However, there are generally no limitations on the use of losses to offset other income of an acquired business.

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[86] Special rules apply for real estate investment trusts, which may carry loses forward but not back. Certain specified liability losses can be carried back for 10 years.

[87] See, e.g., H.R. Rep. No. 99–426, 99th Cong, 1st sess, (December 7, 1985) at pp. 255–256.

3. Treatment of intangible assets

Self-created intangible assets

Under present law, many expenditures by a business that may contribute to the creation of intangible assets are currently deductible as expenses of doing business. Thus, for example, salaries of employees, advertising, and other operating expenses generally are currently deductible, even though these expenditures may create or enhance the goodwill, going concern value, reputation, or customer base of the business. Expensing generally is allowed under present law because of the administrative difficulty of ascertaining the extent to which these expenditures contribute to the value of the intangible asset.[88]

Expenditures for other types of intangible assets that have a demonstrable useful life longer than a year are generally capitalized and amortized over the life of the asset. Examples include up-front payments for the acquisition of leases or other contracts or rights, or amounts spent to develop software or other intangible assets.

Purchased intangible assets

Prior to the Omnibus Budget Reconciliation Act of 1993 (the "1993 Act"), amounts expended to purchase intangible assets were generally capitalized and, if the asset had a useful life that could be determined with reasonable accuracy, amortized over that useful life. When intangible assets were acquired as part of the acquisition of a trade or business, issues frequently arose regarding the allocation of purchase price among various assets, and regarding whether particular assets had a useful life determinable with reasonable accuracy. It was generally accepted that certain assets (e.g., stock) did not have a determinable useful life, while other assets (e.g., computer software) might have a relatively short useful life (the IRS issued a revenue procedure permitting the write-off of software generally over 5 years or such shorter life as the taxpayer could demonstrate). Numerous disputes arose, however, over the proper treatment of customer lists and supplier-based intangibles. Treasury Regulations provided that no deduction was permitted for goodwill or going concern value. The U.S. Supreme Court held that a taxpayer able to prove that a particular asset can be valued, and that the asset has a limited useful life which can be ascertained with reasonable accuracy, may depreciate the value over the useful life regardless of how much the asset appears to reflect the expectancy of continued patronage. However, the Supreme Court characterized the taxpayer's burden as "substantial" and stated that it "often will prove too great to bear." *Newark Morning Ledger Co. v. United States*, 113 S.Ct. 1670 (1993).

The 1993 Act provided special treatment under section 197 for most purchased intangible assets, requiring amortization of all such assets on a straight line method over a statutory 15 year period. The reason for this treatment was to simplify the determination of allocation and of useful life by providing the same amortization for a wide range of assets. This treatment applies generally to goodwill and going concern value, workforce, information base,

[88] For a further discussion of this difficulty, see the description of section 174 below.

know-how, customer-based intangibles, supplier based intangibles, and other similar items. It also applies to licenses, permits and other rights granted by governmental units, covenants not to compete and other similar arrangements, franchises, trademarks, and trade names. Certain items are excepted from this treatment if they are not acquired in connection with the acquisition of assets constituting a trade or business, and certain other items are excepted even in the case of a business acquisition. Excepted items include certain computer software (for which a three-year life is provided); interests in a corporation, partnership, trust or estate; interests in land; interests under certain financial contracts; certain interests in films, sound recordings, video tapes, books, or other similar property; certain interests in patents or copyrights; certain rights to receive tangible property or services; interests under leases of tangible property; interests under indebtedness; professional sports franchises; and certain transactions costs in transactions in which gain or loss is not recognized under the tax-free reorganization or certain other tax-free transaction rules of the Code. Moreover, the 1993 Act provision does not apply to intangible assets that are created by the taxpayer and the provision generally does not require costs that were expensed and deducted by taxpayer to be capitalized and amortized (except in the case of certain covenants-not-to-compete).

4. Section 174 expensing of research or experimental expenditures

In 1954, Congress enacted section 174, specifically addressing for the first time in the Code the treatment of research expenses. The objective underlying section 174 was both to reduce uncertainties regarding the timing for claiming research expense deductions and to encourage investment in research.[89]

Section 174 provides taxpayers with two methods for deducting "research or experimental expenditures" incurred in connection with a trade or business. Taxpayers may choose either to deduct such research or experimental expenditures currently in the taxable year in which such expenses are paid or incurred (sec. 174(a)), or, alternatively, taxpayers may choose to treat such expenditures as deferred expenses, amortizable over a period of not less than 60 months (sec. 174(b)).[90] If a taxpayer elects to deduct currently re-

[89] Prior to 1954, there was considerable controversy regarding the proper treatment of research expenses for tax purposes. Court decisions generally had required capitalization of research expenses, while the IRS, as a matter of practice, generally had allowed businesses to adopt a policy of deducting such expenses currently. *See generally* M. McConaghy and R. Ruge, "Congressional Intent, Long-standing Authorities Support Broad Reading of Section 174," *Tax Notes*, February 1, 1993., at 639–653; D. Hudson, "The Tax Concept of Research or Experimentation," 45 *Tax Lawyer* 85–121 (1993). Current losses generally were permitted where amounts had been capitalized in connection with abandoned projects; but recovery through amortization was supposed to be the norm where the research expenses were viewed as capital in nature and an identifiable asset with a determinable useful life resulted from the research, as in the case of a patent. One particular problem was attempting to determine whether costs associated with unsuccessful research should be deducted immediately or allocated to other on-going research projects with varying degrees of success. *Id.*

[90] This second alternative under section 174(b) of treating research expenses as deferred expenses (deducted ratably over a period of not less than 60 months beginning with the month in which the taxpayer first realizes benefits from the expenditures) applies *only if* the property resulting from the research expenses has no determinable useful life. If the property resulting from the expenses has a determinable useful life, the section 174(b) alternative is not applicable, and the capitalized expenditures must be amortized or depreciated over the determinable useful life (sec. 174(b)(1)(C) and Treas. Reg. sec. 1.174–4).

search or experimental expenditures under section 174(a), then that method (i.e., expensing) must be used for all such expenditures incurred in the taxable year and all subsequent years, unless the consent of the Commissioner of IRS is obtained to use the deferred-expense method under section 174(b) for one or more particular projects.[91] Section 174 applies not only to costs incurred by a taxpayer for research or experimentation undertaken directly by the taxpayer but also to expenditures paid or incurred for research or experimentation conducted on behalf of the taxpayer by another person or organization (such as a research institute). Expenditures are deductible under section 174 only to the extent they are reasonable under the circumstances (sec. 174(e)).[92]

The Code itself does not contain a specific definition of "research or experimental expenditures." In this regard, however, Treasury Regulations section 1.174–2(a) provides:

> The term research or experimental expenditures, as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. The term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application. Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents.[93]

The term "research or experimental expenditures" does *not* include expenses incurred for the following: ordinary testing or inspection of products for quality control (i.e., to determine whether particular units conform to specified parameters); efficiency surveys; management studies; consumer surveys; advertising or promotions; the acquisition of another person's patent, model, produc-

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[91] See Treas. Reg. sec. 1.174–3.

[92] In this context, the reasonableness requirement parallels the reasonable allowance requirement for salaries and other compensation in section 162(a)(1), in that amounts supposedly paid for research may be recharacterized as disguised dividends, gifts, loans, or other similar payments. The reasonableness requirement under section 174 is not to be used to question whether research activities themselves are of a reasonable type or nature (Treas. Reg. sec. 1.174–2(a)(6)).

[93] The Service has taken the position that software development costs may be treated as research or experimental expenditures for purposes of section 174. See Rev. Proc. 69–21, 1969–2 C.B. 303.

tion or process; or research in connection with literary, historical, or similar projects (Treas. Reg. sec. 1.174–2(a)(3)).[94]

Two types of expenditures specifically are excluded by statutory language from being within the scope of section 174: (1) expenditures for the acquisition or improvement of land or of depreciable (or depletable) property, regardless of whether the property or improvements are used in connection with research or experimentation,[95] and (2) exploration expenditures to ascertain the existence, location, extent, or quality of mineral deposits or oil or gas (secs. 174(c) and (d)). Thus, expenses within the scope of section 174 generally are limited to costs of wages paid for services performed in research activities and supplies and materials used in such activities. In this regard, Treasury regulations clarify that expenditures for research or experimentation which result, as an end product of the research or experimentation, in depreciable property to be used in the taxpayer's trade or business may be allowable as a current expense under section 174(a), but only to the extent of the amounts expended for research or experimentation and not the costs of component materials of the depreciable property, the costs of labor or other elements involved in its construction and installation, or costs attributable to the acquisition or improvement of the property.[96] If expenditures for research or experimentation are incurred in connection with the construction or manufacture of depreciable property by another person, such expenditures (again, *not* including costs of component materials, labor, and other elements involved in the construction of depreciable property) are deductible under section 174(a) only if made upon the taxpayer's order and at the taxpayer's risk.[97]

5. Research and experimentation tax credit

General rule

Prior to July 1, 1995, section 41 of the Code provided for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and does not apply to amounts paid or incurred after June 30, 1995.[98]

A 20-percent research tax credit also applied to the *excess* of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities

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[94] Congress used the term "research and experimental" in section 174 rather than "research and development," in an attempt to clarify that the scope of section 174 generally did not apply to ordinary quality control inspection of products, or market development or sales promotion activities. See McConaghy and Ruge, *supra*, at 644.

[95] For example, the cost of a research building or equipment used for research cannot be expensed or amortized under section 174.

[96] Treasury Regulations section 1.174–2(b)(4) provides the following example of the operation of these rules under section 174: A taxpayer undertakes to develop a new machine for his business and he expends $30,000 on the project of which $10,000 represents the actual costs of material, labor, etc., to construct the machine, and $20,000 represents research costs which are not attributable to the machine itself. Under section 174(a) the taxpayer would be permitted to deduct the $20,000 as expenses not chargeable to capital account, but the $10,000 must be charged to the asset account (the machine).

[97] Treasury Regulation section 1.174–2(b)(3).

[98] The research tax credit originally was enacted in 1981 as a credit equal to 25 percent of the excess of qualified research expenses incurred during the current taxable year over the average of qualified research expenses incurred during the prior three taxable years. The research tax credit was modified and temporarily extended several times by legislation enacted during the period 1986 through 1993.

(and certain nonprofit scientific research organizations) *over* (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the "university basic research credit" (see sec. 41(e)).

Computation of allowable credit

Under section 41, the research tax credit applies (except for certain university basic research payments made by corporations) only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984–1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.[99]

In computing the credit, a taxpayer's base amount may not be less than 50 percent of its current-year qualified research expenditures. This rule is referred to as the "50-percent base limitation."

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, research expenditures and gross receipts of the taxpayer are aggregated with research expenditures and gross receipts of certain related persons for purposes of computing any allowable credit (sec. 41(f)(1)). Special rules apply for computing the credit when a major portion of a business changes hands, under which qualified research expenditures and gross receipts for periods prior to the change or ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage (sec. 41(f)(3)).

Eligible expenditures

Qualified research expenditures eligible for the research tax credit consist of: (1) "in-house" expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of

[99] The Omnibus Budget Reconciliation Act of 1993 included a special rule designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm (i.e., any taxpayer that did not have gross receipts in at least three years during the 1984–1988 period) will be assigned a fixed-base percentage of 3 percent for each of its first five taxable years after 1993 in which it incurs qualified research expenditures. In the event that the research credit is extended beyond the June 30, 1995 expiration date, a start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenditures will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage will be its actual ratio of qualified research expenditures to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called "contract research expenses").

To be eligible for the credit, the research activity must not only satisfy the requirements of present-law section 174 (discussed above) but must satisfy certain additional statutory criteria. "Qualified research" for purposes of the credit is limited to research undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and the research must relate to functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors (sec. 41(d)(3)). In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control (sec. 41(d)(4)).

Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

Relation of credit to deductions

Deductions allowed to a taxpayer for research expenses under section 174 are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year. Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

6. Orphan drug tax credit

Prior to January 1, 1995, a 50-percent nonrefundable tax credit was allowed for qualified clinical testing expenses incurred in testing of certain drugs for rare diseases or conditions, generally referred to as "orphan drugs." [100] Qualified testing expenses are costs incurred to test an orphan drug after the drug has been approved for human testing by the Food and Drug Administration ("FDA") but before the drug has been approved for sale by the FDA. A rare disease or condition is defined as one that (1) affects less than 200,000 persons in the United States or (2) affects more than 200,000 persons, but for which there is no reasonable expectation that businesses could recoup the costs of developing a drug for it from U.S. sales of the drug. These rare diseases and conditions include Huntington's disease, myoclonus, ALS (Lou Gehrig's disease),

[100] The orphan drug tax credit originally was enacted in 1983 and was temporarily extended several times by legislation enacted during the period 1986 through 1993.

Tourette's syndrome, and Duchenne's dystrophy (a form of muscular dystrophy).

Under prior law, the orphan drug tax credit could be claimed by a taxpayer only to the extent that its regular tax liability for the year the credit was earned exceeded its tentative minimum tax for that year, after regular tax was reduced by nonrefundable personal credits and the foreign tax credit. Unused credits could not be carried back or carried forward to reduce taxes in other years.

As with the research tax credit, deductions allowed under section 174 are reduced by an amount equal to 100 percent of the taxpayer's orphan drug tax credit determined for the taxable year (sec. 280C(b)).

B. Analysis of Impact on Start-up and Research Companies

1. Start-up and organizational expenses and use of net operating losses

Overview

Under present law,[101] taxpayers may elect to amortize start-up expenditures, incurred before the commencement of the trade or business, over a period of 60 months. Unless this election is made, such expenditures are not deductible, but must be capitalized and recovered on the disposition or abandonment of the business. Issues may arise regarding whether a particular activity involves the "start-up" of a new trade or business in which case the expenditures are subject to the start-up rules, or the expansion of an existing trade or business, in which case the expenditures may be currently deductible.

Expenses of organizing a business entity also are not deductible unless an election is made, in which case they also may be amortized over a period of 60 months.

Net operating losses ("NOLs") are computed for a taxable year as the excess of allowable deductions over gross income for that year, with certain modifications. NOLs generally may be carried back to the prior three taxable years and carried forward for the fifteen taxable years succeeding the loss year. Carrying back NOLs against prior taxable income allows the benefit of the loss to be recognized in the current year by obtaining a refund of prior taxes paid. Carryovers of NOLs generally are allowed because the natural business cycles of an entity may not match the taxable year accounting periods required under present law.

The carry forward of losses is subject to special limitations if a business experiences an "ownership change" (sec. 382). In general, an ownership change occurs if more than 50 percent of the interests of 5-percent or greater shareholders are acquired by other such shareholders within a three-year period. The purpose of this limitation generally is to reduce incentives for acquiring or investing in a business at a price that reflects the ability of the new owners to shelter their anticipated future income with losses that arose before their ownership, which potentially may involve new business opportunities or capital that would not have been available to the old owners.

Consumption tax

A consumption tax generally would not involve start-up or organizational expenditure considerations. Under a consumption tax, start-ups presumably would be permitted to expense items in the same manner as an expanding business, thus removing the tension between these two situations under present law.

Current expensing could create even greater NOLs for start-ups than under present law. This is because the entire cost of business assets would be deducted in the year of purchase, even though, for an asset with a useful life longer than a year, a significant amount

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[101] A more complete description of present law appears under the headings "Start up expenditures and organizational expenditures" and "Net operating losses," in the Part II.A discussion of "Present Law and Background," *supra*.

of the total income generated by the asset would not be expected to be produced until later years. Thus, in a start-up situation, the business would not become taxable until the year in which it has produced total income exceeding the cost of all its originally acquired assets.

A decision would have to be made regarding the treatment of NOLs. One option is to allow taxpayers with NOLs to obtain refunds. This treatment is according to NOLs in most VATs enacted in other countries and in S. 2160, the Business Activities Tax version of a VAT introduced by Senators Boren and Danforth. Refunds are generally allowed for net operating losses (or the excess of tax paid on inputs over the tax charged on outputs in a credit-invoice VAT) in order to avoid a potential cascading of the tax accrued through the stage of production the loss company occupies.[102] This treatment would allow refunds not only to taxpayers that had not yet earned the anticipated future income but would reasonably be expected to earn it, but also to taxpayers who made unsuccessful business judgements and would be unable to utilize the losses at any future period.

Other options are to carry forward losses, as under present law, or with interest, as under H.R. 2010 and S. 1050. If carryforwards are allowed, a decision would have to be made whether to impose rules similar to present law section 382, limiting the use of losses when a business ownership changes significantly and curtailing some of the incentives to acquire a troubled business for a price reflecting the value of the losses to the new owners. However, if these rules are too restrictive, this could discourage start-ups by new enterprises and encourage start-ups by entities with sufficient taxable income to absorb the loss.

"Pure" income tax

In theory, a "pure" income tax might eliminate the elections to amortize start-up and organizational expenditures. The rationale for eliminating such elections would be that a "pure" income tax theoretically matches income for a period with expenditures applicable to that period; and if the useful life of the expenditures cannot be determined, no reasonable amortization schedule can be created. Since start-up and organizational expenditures occur before business has begun; and since they may be deemed to benefit the business over the period of its entire life, which is unknown, any amortization might be considered inappropriate to a "pure" income tax. On the other hand, such a tax might be structured to include some taxpayer-favorable rules of administrative convenience, such as the present-law elections.

If a "pure" income tax were structured to eliminate the options to amortize start-up and organizational expenses, this could increase the importance of determining whether a business is a "start-up" or an expansion of an existing business.

Apart from start-up and organizational expenses, a "pure" income tax might also reduce the ability to deduct currently certain other amounts in excess of economic depreciation, or otherwise at-

[102] See *Joint Committee on Taxation, Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS–18–95), June 5, 1995, pp. 17–28.

tempt to achieve better matching of interperiod income and deductions. The effect might be to reduce NOL carryforwards of start up businesses. In some cases, (if a provision such as the present law ownership change rules were retained) this might benefit businesses that seek significant amounts of additional capital in a manner that would cause an ownership change, since the losses would not be incurred before the change and thus would not be limited.

As in the case of a consumption tax, a decision would have to be made regarding the treatment of any NOLs; i.e., whether to permit refunds or to carry forward losses and, if carryforwards are permitted, whether to limit the use of such carryforwards in a manner similar to present-law section 382.

2. Tax treatment of research activities and intangible assets

Overview

Technological development is an important component of economic growth. However, while an individual business may find it profitable to undertake some research, it may not find it profitable to invest in research as much as it otherwise might because it is difficult to capture the full benefits from the research and prevent such benefits from being used by competitors. In general, businesses acting in their own self-interest will not necessarily invest in research to the extent that would be consistent with the best interests of the overall economy. This is because costly scientific and technological advances made by one firm are cheaply copied by its competitors. Research is one of the areas where there is a consensus among economists that government intervention in the marketplace can improve overall economic efficiency.[103] However, this does not mean that increased tax benefits or more government spending for research always will improve economic efficiency. It is possible to decrease economic efficiency by spending too much on research. It is difficult to determine whether, at the present levels of government subsidies for research, further government spending on research or additional tax benefits for research would increase or decrease overall economic efficiency. There is no evidence that the current level of research undertaken in the United States, or worldwide, is too little or too great to maximize society's well-being.

If it is believed that too little research is being undertaken, a tax subsidy is one method of offsetting the private-market bias against research, so that research projects undertaken approach the optimal level. Among the other policies employed by the Federal Government to increase the aggregate level of research activities are direct spending and grants, favorable anti-trust rules, and patent protection. The effect of tax policy on research activity is largely uncertain because there is little evidence about the responsiveness of research to changes in taxes and other factors affecting its price. To the extent that research activities are responsive to the price of research activities, tax reform that adopts either a pure income tax or a consumption-based tax would be expected to alter the price of research compared to present law. In addition, adoption of a pure income tax could re-introduce complexities and compliance costs of

[103] This conclusion does not depend upon whether the basic tax regime is an income tax or a consumption tax.

prior law. In contrast, adoption of a consumption-based tax generally would eliminate certain complexities and compliance costs that exist relating to the present-law treatment of research expenditures.

The scope of present-law tax expenditures on research activities

The tax expenditure related to the expensing of research and development expenditures is estimated to be $2.5 billion for 1996 growing to $3.2 billion for 2000.[104] Under prior law, in 1993, approximately $1.9 billion in research credits were allowed to be claimed. While research undertaken by firms that qualify for the research tax credit does not constitute all research undertaken by taxpayers in the United States, Table 10 documents the growth in qualifying research expenditures under both the research tax credit and the orphan drug credit for the period 1984 to 1993. However, these data represent nominal (not inflation adjusted) dollars. In the case of the research tax credit, real (inflation adjusted) qualifying expenditures declined slightly between 1984 and 1993.

[104] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1996–2000*, (JCS–21–95), September 1, 1995, p.12.

Table 10.—Corporate Returns Claiming R&E Credit and Orphan Drug Credit, 1984–1993

Item	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
R&E Credit										
Number of firms	15,933	15,128	12,936	11,064	11,673	12,688	12,169	12,346	11,826	13,764
Qualifying expenditures ($ millions)	31,653	35,084	28,573	30,481	33,428	36,653	40,009	40,204	43,291	41,435
Tax credit allowed ($ millions)	2,656	2,800	1,310	1,091	1,320	1,392	1,607	1,648	1,579	1,893
Orphan Drug Credit										
Number of firms	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)
Qualifying expenditures ($ millions)	(2)	(2)	13	13	16	28	(31)	44	50	55
Tax credit claimed ($ millions)	(2)	(2)	7	6	8	14	(16)	22	25	28

[1] Number not disclosed to protect taxpayer confidentiality.
[2] Less than $500,000.

Source: Joint Committee on Taxation calculations from Internal Revenue Service, *Statistics of Income* data.

Tables 11 and 12 present data for 1993 on those industries that utilized the research tax credit and the distribution of the credit claimants by firm size. Three quarters of the research tax credits claimed are claimed by taxpayers whose primary activity is manufacturing. Nearly two thirds of the credits claimed are claimed by large firms (assets of $500 million or more). Nevertheless, as Table 12 documents, a large number of small firms are engaged in research and are able to claim the research tax credit.

Table 11.—Percentage Distribution of Firms Claiming R&E Credit and of Amount of Credit Claimed by Sector, 1993

Sector	Number of firms (percent)	Credit claimed (percent)
Agriculture, Forestry and Fishing	(1)	(1)
Mining	(1)	(1)
Construction	0.7	0.4
Manufacturing	58.0	75.2
Transportation, Communication, and Public Utilities	1.4	8.1
Wholesale and Retail Trade	9.1	2.6
Finance, Insurance, and Real Estate	1.5	1.3
Services	28.3	12.0

[1] Data undisclosed to protect taxpayer confidentiality.

Source: Joint Committee on Taxation calculations from Internal Revenue Service, *Statistics of Income* data.

Table 12.—Percentage Distribution of Firms Claiming R&E Credit and of Amount of Credit Claimed by Firm Size, 1993

Firm size ($ assets)	Number of firms (percent)	Credit claimed (percent)
≤0	0.6	0.2
1 to 100,000	13.4	0.4
100,000 to 250,000	6.0	0.5
250,000 to 500,000	10.2	0.9
500,000 to 1 million	14.6	1.4
1 million to 10 million	32.7	7.9
10 million to 50 million	12.2	8.5
50 million to 100 million	2.8	4.2
100 million to 250 million	2.4	5.0
250 million to 500 million	1.4	6.0
500 million and over	3.7	64.9

Source: JCT calculations from Internal Revenue Service, *Statistics of Income* data.

The responsiveness of research expenditures to tax incentives

Like any other commodity, the amount of research expenditures that a firm wishes to incur generally is expected to respond positively to a reduction in the price paid by the firm. Economists often

refer to this responsiveness in terms of "price elasticity," which is measured as the ratio of the percentage change in quantity to a percentage change in price. For example, if demand for a product increases by five percent as a result of a 10-percent decline in price paid by the purchaser, that commodity is said to have a price elasticity of demand of 0.5.[105] One way of reducing the price paid by a buyer for a commodity is to grant a tax credit upon purchase. A tax credit of 10 percent (if it is refundable or immediately usable by the taxpayer against current tax liability) is equivalent to a 10-percent price reduction. If the commodity granted a 10-percent tax credit has an elasticity of 0.5, the amount consumed will increase by five percent. Thus, if a flat research tax credit were provided at a 10-percent rate, and research expenditures had a price elasticity of 0.5, the credit would increase aggregate research spending by five percent.[106]

Despite the central role of the measurement of the price elasticity of research activities, there is little empirical evidence on this subject. What evidence exists generally indicates that the price elasticity for research is substantially less than one. For example, one survey of the literature reached the following conclusion:

> In summary, most of the models have estimated long-run price elasticities of demand for R&D on the order of −0.2 and −0.5. . . . However, all of the measurements are prone to aggregation problems and measurement errors in explanatory variables.[107]

Although most analysts agree that there is substantial uncertainty in these estimates, the general consensus when assumptions are made with respect to research expenditures is that the price elasticity of research is less than 0.5.[108]

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[105] For simplicity, this analysis assumes that the product in question can be supplied at the same cost despite any increase in demand (i.e., the supply is perfectly elastic). This assumption may not be valid, particularly over short periods of time, and particularly when the commodity—such as research scientists and engineers—is in short supply.

[106] It is important to note that not all research expenditures need be subject to a price reduction to have this effect. Only the expenditures which would not have been undertaken otherwise—so called marginal research expenditures—need be subject to the credit to have a positive incentive effect.

[107] Charles River Associates, *An Assessment of Options for Restructuring the R&D Tax Credit to Reduce Dilution of its Marginal Incentive* (final report prepared for the National Science Foundation), February, 1985, p. G–14.

[108] In a 1983 study, the Treasury Department used an elasticity of .92 as its upper range estimate of the price elasticity of R&D, but noted that the author of the unpublished study from which this estimate was taken conceded that the estimate might be biased upward. See, Department of the Treasury, *The Impact of Section 861–8 Regulation on Research and Development*, p. 23. As stated in the text, although there is uncertainty, most analysts believe the elasticity is considerable smaller. For example, the General Accounting Office summarizes: "These studies, the best available evidence, indicate that spending on R&E is not very responsive to price reductions. Most of the elasticity estimates fall in the range of–0.2 and–0.5 . . . . Since it is commonly recognized that all of the estimates are subject to error, we used a range of elasticity estimates to compute a range of estimates of the credit's impact." See, *The Research Tax Credit Has Stimulated Some Additional Research Spending* (GAO/GGD–89–114), September 1989, p. 23. Similarly, Edwin Mansfield concludes: "While our knowledge of the price elasticity of demand for R&D is far from adequate, the best available estimates suggest that it is rather low, perhaps about 0.3." See, "The R&D Tax Credit and Other Technology Policy Issues," *American Economic Review*, Vol. 76, no. 2, May 1986, p. 191. More recent empirical analyses have estimated higher elasticity estimates. One recent empirical analysis of the research credit has estimated a short-run price elasticity of 0.8 and a long-run price elasticity of 2.0. The author of this study notes that the long-run estimate should be viewed with caution for several technical reasons. In addition, the data utilized for the study cover the period 1980 through 1991, containing only two years under the revised credit structure. This makes it empirically difficult to distinguish short-run and long-run effects, particularly as it may take firms some time to fully appreciate the incentive structure of the revised credit. See, Bronwyn H. Hall, "R&D Tax Policy During the

Tax restructuring and the "price" of research activities

Expenditures on research constitute a cost of producing a product just as compensation of the manufacturing workforce and expenditures on production equipment are costs of producing a product. In determining how to organize production to maximize profits, the business must weigh the relative cost, or "price" of each of research, workforce, and equipment against the additional sales that can be generated by devoting more effort to research versus more capital investment versus more extensive use of labor intensive production methods. In weighing the costs and benefits, the business may substitute between expenditures on capital equipment, expenditures on research activities, and expenditures on its workforce.

The price of research under a "pure" income tax

Under income tax principles, the business's profit that is subject to tax is the receipts from the sale of products less expenses related to the products. Some costs incurred by the business (e.g., the purchase of equipment) relate to products sold in more than one year. Income tax principles provide that the business may only deduct a portion of the expense in any one year. Under a theoretically pure income tax regime, deductions should be matched to the period that income is produced by the deductible expense. To the extent that research expenditures lead to the creation of new products in the future or to improved production processes that may be applied in more than one year, income tax principles would imply that research expenses should be capitalized and recovered over time, as are expenditures on equipment. As explained above, research expenses generally are deductible currently. From a pure income tax perspective, allowing research expenses to be deducted currently (particularly when the research is successful in leading to a profitable commercial application) is one form of tax subsidy for research activities. In addition, present law provides for a tax credit for certain research expenditures. Thus, because of this present-law tax treatment, the price of undertaking research is relatively less than the price of capital equipment, which generally may not be expensed and for which no credit is provided.

Reform in the direction of a pure income tax would increase the price of undertaking research activities. To the extent that business planning of such activities responds to price changes, one would expect research expenditures to decline. However, if adoption of a pure income tax is accompanied by a reduction in income tax rates, the after-tax return to all investments would increase. This would have some offsetting effect on a predicted decline in research ex-

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1980s: Success or Failure?" in James M. Poterba (ed.), *Tax Policy and the Economy*, 7, pp. 1–35 (Cambridge: The MIT Press 1993). Another recent study examined the post–1986 growth of research expenditures by 40 U.S.-based multinationals and found price elasticities between 1.2 and 1.8. However, including an additional 76 firms, that had initially been excluded because they had been involved in merger activity, the estimated elasticities fell by half. See, James R. Hines, Jr., "On the Sensitivity of R&D to Delicate Tax Changes: The Behavior of U.S. Multinationals in the 1980s" in Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod (eds.), *Studies in International Taxation*, (Chicago: University of Chicago Press 1993).

penditures.[109] Nevertheless, under a pure income tax, research would not be favored relative to expenditures on equipment or labor. Thus, the benefits of lower income tax rates would be expected to favor increased expenditures on equipment and labor relative to research activities.

Research activities also could benefit indirectly from the adoption of the pure income tax if, in reducing or eliminating other economic inefficiencies, the demand for research-intensive goods increases, thereby increasing the demand for research expenditures.

The price of research under consumption-based taxes

The flat tax, the subtraction method VAT, and USA Tax business tax described in Part II.B., above, generally permit taxpayers to deduct all expenses for outside research, raw materials, and equipment when incurred, regardless of the specific kind of business activity to which the expense is attributable. The retail sales tax, which taxes final sales of goods and services, also makes no distinction between when such costs are incurred for different business inputs. That is, unlike the present-law income tax, the proposals would treat equally expenditures on outside research and expenditures on equipment.[110] Under the flat tax, the subtraction-method VAT, and the business component of the USA Tax, both types of expenditures would be deducted from the tax base when they occur. A dollar spent on research would be treated identically to a dollar spent on equipment.[111] Both dollars receive "expensing" treatment. Present-law section 174 provides expensing for certain research expenditures and the research tax credit (if available) reduces still further the price of research activities. Still, other research expenditures, (e.g., the purchase of an electron microscope to be used in a research project) are depreciated.[112] Thus, under a consumption-based tax, the price of certain research expenditures will increase compared to present law, the price of other research expenditures will decline compared to present law, and the price of other research expenditures will remain unchanged compared to present law. If research expenditures are responsive to the price of such expenditures, one would expect some expenditures to decrease, others to increase, and others to remain unchanged compared to present law.

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[109] A significant portion of the benefit of a rate reduction would accrue to "old" investments in research activities, that is, past research for which expenditures were expensed and perhaps received the research tax credit.

[110] The discussion in the text is stated in terms of purchased research. Superficially, in-house research appears to receive different treatment relative to capital equipment expenditures under the flat tax, the subtraction-method VAT, and the business component of the USA Tax in comparison to a retail sales tax because wages of research personnel are part of the tax base (imposed at the individual level under the flat tax) while capital expenditures are not part of the tax base. However, if, as generally believed, the consumption-based taxes are borne by consumers in the form of higher prices or by laborers in the form of lower wages, the tax burden on a dollar of profit generated by research activities is the same as the tax burden on a dollar of profit generated by the purchase of capital equipment. See, Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS–18–95), June 5, 1995, p. 78, and Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens* (JCS–7–93), June 14, 1993, pp. 51–60, for a discussion of the economic incidence of a consumption-base tax.

[111] Similarly, under the sales tax as no expenditure affects the tax base, a dollar spent on research is equivalent to a dollar spent on equipment.

[112] Although, unlike some equipment purchases, equipment used in research receives a five-year life.

However, as with the adoption of a pure income tax, under these proposals, expenditures on research would no longer be relatively cheaper than expenditures on equipment or labor. To the extent that relative prices of different business inputs affect the choice of input mix, the tax reform proposals each make equipment expenditures relatively less expensive. With equipment relatively less expensive than under present law, one might expect businesses to substitute equipment purchases for research expenditures where feasible. This might suggest that if research expenditures are responsive to the price of such expenditures, the magnitude of research expenditures could fall if the income tax were replaced. On the other hand, some have argued that replacement of the income tax will spur aggregate saving and investment.[113] An increase in aggregate investment could lead to an increase in total research expenditures and total equipment expenditures, although the relative price change would suggest that equipment expenditures would grow more than research expenditures.

Research expenditures and simplification

While, as explained above, section 174 has the economic effect of reducing the price of certain research expenditures relative to the price of production equipment, section 174 was enacted (in part) to provide administrative ease to the determination of income subject to tax. However, section 174 itself requires taxpayers to make determinations that may be difficult. For example, under present-law section 174, taxpayers need to distinguish (1) research from quality control testing, (2) research from depreciable property acquisition costs, and (3) scientific from literary or historical research.

Administrative and compliance burdens also result from the present-law research tax credit. The General Accounting Office ("GAO") has testified that the research tax credit is difficult for the IRS to administer. The GAO reports that the IRS view is that it is "required to make difficult technical judgments in audits concerning whether research was directed to produce truly innovative products or processes." While the IRS employs engineers in such audits, the companies engaged in the research typically employ personnel with greater technical expertise and, as would be expected, personnel with greater expertise regarding the intended application of the specific research conducted by the company under audit. Such audits create a burden for both the IRS and taxpayers. The credit generally requires taxpayers to maintain records more detailed than those necessary to support the deduction of research expenses under section 174.[114]

The above definitional issues related to research activities, and associated administrative and compliance burdens, would be eliminated under a consumption-based tax, because purchases by businesses for all their activities (research and non-research) generally would be expensed. There would be no need to determine whether

[113] See, Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax*, pp. 61–68, for a discussion of the effects on saving and investment from replacement of the income tax with a consumption-base tax.

[114] Natwar M. Gandhi, Associate Director Tax Policy and Administration Issues, General Government Division, U.S. General Accounting Office, "Testimony before the Subcommittee on Taxation and Internal Revenue Service Oversight," Committee on Finance, United States Senate," April 3, 1995.

particular projects or product development costs are "research or experimental expenditures" as that term is used in section 174 or "qualified research" tax as that term is used for purposes of the present-law research credit. This would eliminate highly technical and fact-based disputes between taxpayers and the IRS that arise under present law, and would reduce taxpayers' record-keeping burdens.

Under a pure income tax regime, however, capitalization of business expenses generally is required. This would re-introduce accounting problems that existed prior to the enactment of section 174. If a particular research project did not result in an identifiable asset, capitalized expenses could not be deducted until the research proved to be a failure or the project was completely abandoned. Prior to the enactment of section 174, when research was conducted as part of an ongoing project, taxpayers had difficulty determining when complete abandonment of a particular aspect of the research occurred. Even when an identifiable asset resulted, it was difficult to determine what aspects should be capitalized when not all of the research efforts were successful, when multiple research efforts led to the creation of the asset, or when multiple assets resulted from one research project.[115] Inevitably, tax accounting conventions (similar to the 15-year amortization period provided for by present-law section 197 for certain intangible assets) might have to be adopted in order to reduce uncertainties regarding the proper amortization period for certain research expenses.

Tax restructuring and the treatment of intangibles assets

Overview

Businesses often use their intangible assets to produce earnings over a span of years. In this way intangible assets are economically equivalent to tangible assets. However, present law provides disparate treatment between intangible and tangible assets. Moreover, present law provides disparate treatment among intangible assets depending upon whether they are self-created or purchased. Tax reform adopting either a consumption-based tax like the flat tax, the subtraction-method VAT, the business tax component of the USA Tax, or a national sales tax or a pure income tax would eliminate both the disparate treatment between intangible and tangible assets and the disparate treatment among self-created and purchased intangible assets.

While the costs of tangible assets such as equipment generally must be capitalized and recovered through depreciation, whether purchased or self-created, the expenses incurred in creating self-created intangible assets generally may be deducted currently (expensed). Thus, for example, expenditures on advertising that promote a recognizable brand name and goodwill may be expensed, while expenditures on capital equipment that will produce the product that bears the brand name generally must be deducted over time. Because the economic value of a deduction is greater if it may be claimed earlier rather than later, creation of intangible assets is relatively cheaper than the creation of physical assets. Similarly, some purchased intangible assets are relatively cheaper

[115] See D. Hudson, *supra*, at pp. 88–89.

than other intangible assets and may, or may not, be relatively cheaper or more expensive than different tangible assets. This arises because, as explained in Part III.A.3, above, purchased intangibles, regardless of their economic lives, generally may be amortized over 15 years. Those purchased intangible assets for which 15 years overstates their economic lives are relatively more expensive than those purchased intangible assets for which 15 years understates their economic lives. By the same argument, purchased intangible assets are relatively more expensive than self-created intangible assets.

Consumption-based taxation

Adoption of a consumption-based tax would permit the purchase of all assets to be expensed. Expenditures on the creation of intangible assets would no longer be relatively cheaper than expenditures on equipment. Similarly, any relative differences between different purchased intangible assets would be eliminated. Lastly, purchased intangible assets would be treated identically to self-created intangible assets. Self-created intangible assets might appear to be disadvantaged relative to purchased intangibles or equipment under the flat tax, the subtraction-method VAT, or the business component of the USA Tax because wages of employees engaged in the creation of intangibles are part of the tax base, while purchased goods are not. However, if as generally believed, the consumption-based taxes are borne by consumers in the form of higher prices or by laborers in the form of lower wages, the tax burden on a dollar of profit generated by creating intangible assets is the same as the tax burden on a dollar of profit generated by the purchase of intangible assets and is the same as the tax burden on a dollar of profit generated by the purchase of capital equipment.

To the extent that relative prices of different business inputs affect the choice of business investment, the tax reform proposal, by making tangible assets relatively cheaper, might cause businesses to substitute equipment purchases for expenditures on the creation of intangible assets where feasible. This could lead to a decline in aggregate expenditures on the creation of intangible assets. On the other hand, if replacement of the income tax spurs aggregate saving and investment, total expenditures on both tangible and intangible assets could rise, although the relative price change would suggest that equipment expenditures would rise more than expenditures on intangibles.

Adoption of one of the consumption-based taxes also would ease compliance burdens regarding expenses related to intangibles. Expensing removes the need for maintaining records across years. However, the enactment of section 197 probably eliminated many of the sources of ambiguity and contention that existed in prior law relating to the tax treatment of purchased intangibles.

"Pure" income taxation

Adoption of a pure income tax also would eliminate the relative price differences that exist under present law between self-created and purchased intangible assets and between intangible assets and tangible assets. A pure income tax would accomplish this by requiring the capitalization of expenses related to the creation of intangi-

ble assets and by establishing different depreciable lives (corresponding to "true" economic lives) for different types of tangible assets, whether those assets are purchased or self-created. Reform in this direction would generally increase the price of intangible assets. To the extent that business planning responds to price changes, one would expect the expenditure on intangible assets to decline. If adoption of a pure income tax is accompanied by a reduction in income tax rates, the after-tax return to all investments would increase and investments of all types might increase. However, the benefits of lower income tax rates would be expected to favor other expenditures such as equipment purchases relative to expenditures on intangible assets.

Creation of appropriate class lives is in itself quite difficult and even if successfully accomplished would involve an increase in record-keeping requirements and complexity for taxpayers. For self-created intangible assets it would become necessary to apportion in-house expenditures across multiple assets. One would expect that litigation on issues prevalent prior to the enactment of section 197 would re-emerge.

APPENDIX:

DATA ON C CORPORATIONS, S CORPORATIONS AND PARTNERSHIPS BY INDUSTRY AND SIZE

The Appendix contains tables classifying C corporations, S corporations, and partnerships by the amount of their assets and gross receipts. The tables are based on 1993 data from the IRS's Statistics of Income. This information corresponds to Tables 4 through 6 in the text, which showed information on all businesses with the particular form of organization. The Appendix tables disaggregate the data for C corporations, S corporations, and partnerships by the primary industrial category of the business. The number of returns column shows the number of tax returns within a particular classification of asset (or gross receipt) size. The total assets and gross receipts columns show the respective amounts of assets and gross receipts of the businesses within the size classes. The cumulative percent columns show the fraction of the total returns (or assets or gross receipts) represented by all size classes up to and including a particular row. For example, in Table A–1 the entries for the row labeled $250,000 show that 13,060 returns were filed by C corporations whose primary business was agriculture, forestry or fishing and whose total assets were in excess of $100,000 but less than $250,000. The total amount of assets held by those 13,060 C corporations was $2.082 billion. The total number of C corporations in agriculture, forestry or fishing who had assets of less than $250,000 represented 58.18 percent of all C corporations in agriculture, forestry or fishing. Those firms with less than $250,000 in assets held, in aggregate, 6.35 percent of the assets held by C corporations in agriculture, forestry or fishing.

Table A–1.—Distribution of C Corporations, 1993: Agriculture, Forestry and Fishing

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	3,224	.....	4.21	.....
$25,000	11,702	$116	19.50	0.24
$50,000	7,606	280	29.43	0.81
$100,000	8,948	619	41.12	2.08
$250,000	13,060	2,082	58.18	6.35
$500,000	13,296	4,699	75.54	15.99
$1,000,000	10,660	7,596	89.46	31.58
$10,000,000	7,731	16,748	99.56	65.94
$50,000,000	257	5,282	99.90	76.78
$100,000,000	43	3,044	99.95	83.02
Over $100,000,000	35	8,276	100.00	100.00
Total	76,562	$48,742		

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	10,436	.....	13.63	.....
$2,500	1,009	$1	14.95	0.00
$5,000	374	2	15.44	0.01
$10,000	1,629	11	17.56	0.02
$25,000	5,295	89	24.48	0.18
$50,000	6,312	240	32.73	0.59
$100,000	8,837	628	44.27	1.65
$250,000	15,673	2,536	64.74	5.97
$500,000	12,609	4,442	81.21	13.54
$1,000,000	6,270	4,523	89.40	21.24
$10,000,000	7,546	20,183	99.25	55.62
$50,000,000	467	9,196	99.86	71.28
Over $50,000,000	106	16,863	100.00	100.00
Total	76,562	$58,715		

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–2.—Distribution of C Corporations, 1993: Mining

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	1,997	.....	10.68	.....
$25,000	3,889	$36	31.48	0.02
$50,000	1,260	45	38.21	0.04
$100,000	2,048	145	49.17	0.11
$250,000	2,352	373	61.74	0.29
$500,000	2,497	922	75.10	0.72
$1,000,000	2,071	1,488	86.17	1.43
$10,000,000	1,874	5,783	96.19	4.18
$50,000,000	422	8,806	98.45	8.37
$100,000,000	93	6,646	98.95	11.54
Over $100,000,000	198	185,897	100.00	100.00
Total	18,700	$210,142	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	3,732	.....	19.96	.....
$2,500	1,195	$1	26.35	0.00
$5,000	73	0	26.74	0.00
$10,000	276	2	28.21	0.00
$25,000	1,469	27	36.07	0.03
$50,000	1,356	50	43.32	0.09
$100,000	2,148	160	54.81	0.27
$250,000	2,949	440	70.58	0.75
$500,000	2,010	699	81.33	1.53
$1,000,000	1,002	746	86.68	2.35
$10,000,000	1,966	5,518	97.20	8.46
$50,000,000	338	7,570	99.01	16.84
Over $50,000,000	187	75,128	100.00	100.00
Total	18,700	$90,341	.....	.....

Source: JCT calculations from IRS *Statistics of Income,* data.

Table A–3.—Distribution of C Corporations, 1993: Construction

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	9,648	.....	4.29	.....
$25,000	54,818	$516	28.68	0.31
$50,000	24,948	895	39.78	0.85
$100,000	29,861	2,197	53.07	2.17
$250,000	38,009	6,299	69.98	5.95
$500,000	27,720	9,862	82.31	11.87
$1,000,000	19,077	13,306	90.80	19.86
$10,000,000	19,464	49,081	99.46	49.33
$50,000,000	1,004	19,163	99.91	60.83
$100,000,000	112	7,621	99.96	65.41
Over $100,000,000	94	57,609	100.00	100.00
Total	224,755	$166,550	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	16,895	.....	7.52	.....
$2,500	3,606	$5	9.12	0.00
$5,000	1,639	6	9.85	0.00
$10,000	2,676	21	11.04	0.01
$25,000	7,427	126	14.35	0.05
$50,000	11,880	428	19.63	0.17
$100,000	18,336	1,369	27.79	0.58
$250,000	32,761	5,482	42.37	2.21
$500,000	39,621	14,386	59.99	6.50
$1,000,000	37,050	26,471	76.48	14.38
$10,000,000	48,823	130,409	98.20	53.20
$50,000,000	3,617	66,599	99.81	73.02
$Over $50,000,000	424	90,638	100.00	100.00
Total	224,755	$335,941	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–4.—Distribution of C Corporations, 1993: Manufacturing

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	6,757	.....	3.75	.....
$25,000	23,811	$224	16.95	0.01
$50,000	16,907	628	26.32	0.02
$100,000	19,109	1,414	36.91	0.06
$250,000	30,239	5,084	53.68	0.18
$500,000	23,131	8,419	66.50	0.39
$1,000,000	19,862	14,215	77.51	0.74
$10,000,000	31,418	91,793	94.93	3.00
$50,000,000	5,840	126,552	98.17	6.11
$100,000,000	1,166	82,490	98.82	8.14
Over $100,000,000	2,134	3,733,856	100.00	100.00
Total	180,373	$4,064,674	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	9,257	.....	5.13	.....
$2,500	3,138	$4	6.87	0.00
$5,000	840	3	7.34	0.00
$10,000	1,365	10	8.09	0.00
$25,000	5,648	94	11.23	0.00
$50,000	10,231	366	16.90	0.01
$100,000	8,083	594	21.38	0.03
$250,000	25,953	4,614	35.77	0.17
$500,000	24,198	8,726	49.18	0.44
$1,000,000	24,855	18,089	62.96	0.98
$10,000,000	53,453	164,782	92.60	5.97
$50,000,000	9,171	196,712	97.68	11.93
Over $50,000,000	4,181	2,908,282	100.00	100.00
Total	180,373	$3,302,275	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–5.—Distribution of C Corporations, 1993: Transportation, Communcation and Public Utilities

Firms classified by assets less than	Number of returns	Total assets (millions)	Comulative percent	
			Returns	Total assets
$0	7,014	.....	7.08	.....
$25,000	25,541	$235	32.84	0.01
$50,000	9,819	370	42.75	0.03
$100,000	11,733	847	54.59	0.08
$250,000	16,090	2,570	70.82	0.23
$500,000	10,795	3,759	81.71	0.45
$1,000,000	7,583	5,294	89.36	0.76
$10,000,000	8,517	23,363	97.95	2.10
$50,000,000	1,218	25,513	99.18	3.58
$100,000,000	226	16,044	99.41	4.50
Over $100,000,000	588	1,653,413	100.00	100.00
Total	99,124	$1,731,407	.....	.....

Firm classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	8,018	.....	8.09	.....
$2,500	3,471	$4	11.59	0.00
$5,000	1,556	6	13.16	0.00
$10,000	2,283	16	15.46	0.00
$25,000	6,334	110	21.85	0.02
$50,000	5,247	186	27.15	0.04
$100,000	8,495	632	35.72	0.11
$250,000	16,431	2,716	52.29	0.41
$500,000	11,100	4,121	63.49	0.86
$1,000,000	12,991	9,072	76.60	1.86
$10,000,000	20,639	58,548	97.42	8.34
$50,000,000	1,761	35,711	99.19	12.29
Over $50,000,000	796	793,370	100.00	100.00
Total	99,124	$904,493	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–6.—Distribution of C Corporations, 1993: Wholesale and Retail Trade

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	24,931	.....	4.33	.....
$25,000	96,664	$1,022	21.12	0.07
$50,000	59,324	2,163	31.43	0.22
$100,000	80,615	5,875	45.43	0.63
$250,000	112,489	18,442	64.97	1.92
$500,000	79,714	28,319	78.82	3.90
$1,000,000	53,327	37,592	88.08	6.53
$10,000,000	61,813	158,430	98.82	17.61
$50,000,000	5,165	103,703	99.72	24.86
$100,000,000	662	45,860	99.83	28.07
Over $100,000,000	955	1,028,738	100.00	100.00
Total	575,659	$1,430,143	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	25,959	.....	4.51	.....
2,500	7,968	$7	5.89	0.00
$5,000	3,963	14	6.58	0.00
$10,000	9,340	67	8.20	0.00
$25,000	19,226	330	11.54	0.02
$50,000	22,960	861	15.53	0.05
$100,000	39,847	3,027	22.45	0.16
$250,000	93,544	15,646	38.70	0.75
$500,000	89,311	32,215	54.22	1.96
$1,000,000	89,782	64,738	69.82	4.39
$10,000,000	151,046	431,911	96.05	20.60
$50,000,000	18,861	376,260	99.33	34.73
Over $50,000,000	3,853	1,738,464	100.00	100.00
Total	575,659	$2,663,541	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–7.—Distribution of C Corporations, 1993: Finance, Insurance and Real Estate

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	24,676	.....	6.95	.....
$25,000	70,150	$605	26.71	0.00
$50,000	32,402	1,171	38.84	0.01
$100,000	42,410	3,145	47.79	0.04
$250,000	59,546	9,699	64.56	0.12
$500,000	38,451	13,605	75.40	0.22
$1,000,000	28,177	19,991	83.33	0.38
$10,000,000	35,628	102,901	93.37	1.19
$50,000,000	10,459	265,483	96.32	3.29
$100,000,000	4,546	324,206	97.60	5.85
Over $100,000,000	8,524	11,932,132	100.00	100.00
Total	354,969	$12,672,940	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	122,259	.....	34.44	.....
$2,500	11,654	$13	37.73	0.00
$5,000	5,263	20	39.21	0.00
$10,000	12,839	97	42.82	0.01
$25,000	28,622	483	50.89	0.07
$50,000	26,117	970	58.25	0.17
$100,000	32,852	2,393	67.50	0.43
$250,000	43,397	7,011	79.73	1.18
$500,000	31,138	11,056	88.50	2.36
$1,000,000	20,282	14,370	94.21	3.91
$10,000,000	17,599	46,207	99.17	8.86
$50,000,000	1,830	39,498	99.69	13.10
Over $50,000,000	1,116	810,014	100.00	100.00
Total	354,969	$932,133	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–8.—Distribution of C Corporations, 1993: Services

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	33,656	.....	6.31	.....
$25,000	192,520	$1,617	42.44	0.26
$50,000	72,698	2,569	56.08	0.67
$100,000	71,596	5,153	69.51	1.50
$250,000	80,684	12,621	84.65	3.54
$500,000	37,442	13,064	91.67	5.64
$1,000,000	20,582	14,376	95.53	7.96
$10,000,000	20,267	54,380	99.34	16.71
$50,000,000	2,518	53,150	99.81	25.27
$100,000,000	427	30,410	99.89	30.17
Over $100,000,000	593	433,629	100.00	100.00
Total	532,981	$620,971	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	56,524	.....	10.61	.....
$2,500	15,089	$17	13.44	0.00
$5,000	12,901	45	15.86	0.01
$10,000	18,960	137	19.41	0.03
$25,000	32,669	554	25.54	0.12
$50,000	41,670	1,570	33.36	0.38
$100,000	62,781	4,580	45.14	1.13
$250,000	99,159	16,707	63.75	3.87
$500,000	83,195	29,456	79.36	8.69
$1,000,000	54,824	38,287	89.64	14.97
$10,000,000	50,480	130,399	99.11	36.33
$50,000,000	3,713	73,918	99.81	48.44
Over $50,000,000	1,018	314,769	100.00	100.00
Total	532,981	$610,438	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–9.—Distribution of S Corporations, 1993: Agriculture, Forestry and Fishing

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	2,567	.....	3.96	.....
$25,000	15,770	$154	28.31	0.59
$50,000	7,521	277	39.93	1.66
$100,000	8,323	599	52.78	3.98
$250,000	10,848	1,806	69.53	10.95
$500,000	9,197	3,338	83.73	23.84
$1,000,000	5,980	4,194	92.96	40.03
$10,000,000	4,321	9,553	99.63	76.90
$50,000,000	218	4,031	99.97	92.47
$100,000,000	14	883	99.99	95.88
Over $100,000,000	6	1,068	100.00	100.00
Total	64,764	$25,905	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	13,636	.....	21.05	.....
$2,500	1,914	$1	24.01	0.00
$5,000	601	2	24.94	0.01
$10,000	2,251	16	28,41	0.06
$25,000	4,285	72	35.03	0.28
$50,000	3,097	117	39.81	0.63
$100,00	8,727	645	53.29	2.56
$250,000	14,261	2,171	75.31	9.07
$500,000	6,497	2,169	85.34	15.57
$1,000,000	4,333	3,210	92.03	25.19
$10,000,000	4,872	14,022	99.55	67,23
$50,000,000	245	4,960	99.93	82.10
Over $50,000,000	47	5,971	100,00	100.00
Total	64,764	$33,357	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–10.—Distribution of S Corporations, 1993: Mining

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	853	.....	5.12	.....
$25,000	3,910	$28	28.62	0.20
$50,000	2,492	81	43.59	0.79
$100,000	2,286	174	57.32	2.04
$250,000	2,557	394	72.68	4.88
$500,000	1,057	381	79.03	7.63
$1,000,000	1,401	990	87.45	14.76
$10,000,000	1,926	5,352	99.02	53.33
$50,000,000	146	2,820	99.90	73.66
$100,000,000	14	963	99.98	80.60
Over $100,000,000	4	2,692	100.00	100.00
Total	16,645	$13,876	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	3,830	.....	23.01	.....
$2,500	1,521	$1	32.15	0.01
$5,000	372	1	34.38	0.02
$10,000	454	3	37.11	0.04
$25,000	976	16	42.97	0.18
$50,000	1,174	43	50.03	0.55
$100,000	1,860	126	61.20	1.62
$250,000	2,101	290	73.82	4.09
$500,000	1,197	459	81.02	8.01
$1,000,000	930	771	86.60	14.59
$10,000,000	2,064	5,999	99.00	65.76
$50,000,000	152	2,721	99.92	88.96
Over $50,000,000	14	1,294	100.00	100.00
Total	16,645	$11,724	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–11.—Distribution of S Corporations, 1993: Construction

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	10,852	.....	5.64	.....
$25,000	70,732	$650	42.38	0.88
$50,000	24,969	833	55.35	2.01
$100,000	20,885	1,446	66.20	3.96
$250,000	26,628	4,270	80.04	9.74
$500,000	13,778	4,981	87.19	16.48
$1,000,000	11,204	7,779	93.01	27.01
$10,000,000	12,552	34,026	99.54	73.07
$50,000,000	835	14,797	99.97	93.09
$100,000,000	47	3,057	99.99	97.23
Over $100,000,000	12	2,047	100.00	100.00
Total	192,495	$73,885	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions	Cumulative percent	
			Returns	Gross receipts
$0	13,114	.....	6.81	.....
$2,500	3,732	$5	8.75	0.00
$5,000	1,666	7	9.62	0.01
$10,000	2,105	17	10.71	0.01
$25,000	8,643	158	15.20	0.10
$50,000	8,134	287	19.43	0.24
$100,000	21,472	1,566	30.58	1.06
$250,000	42,512	7,127	52.67	4.75
$500,000	31,211	11,122	68.88	10.51
$1,000,000	25,381	17,655	82.06	19.66
$10,000,000	31,533	81,116	98.45	61.70
$50,000,000	2,753	51,450	99.88	88.37
Over $50,000,000	238	22,440	100.00	100.00
Total	192,495	$192,949	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–12.—Distribution of S Corporations, 1993: Manufacturing

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	5,843	.....	4.60	.....
$25,000	32,675	$298	30.32	0.19
$50,000	11,579	411	39.43	0.44
$100,000	12,636	905	49.38	1.01
$250,000	15,754	2,481	61.78	2.55
$500,000	14,369	5,162	73.09	5.77
$1,000,000	11,334	8,084	82.01	10.81
$10,000,000	19,811	60,199	97.60	48.32
$50,000,000	2,748	53,352	99.77	81.57
$100,000,000	213	14,438	99.93	90.57
Over $100,000,000	85	15,130	100.00	100.00
Total	127,046	$160,460	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	8,868	.....	6.98	.....
$2,500	2,562	$3	9.00	0.00
$5,000	4,316	16	12.39	0.01
$10,000	3,588	25	15.22	0.01
$25,000	5,128	85	19.25	0.04
$50,000	5,835	191	23.85	0.09
$100,000	12,334	904	33.56	0.35
$250,000	14,798	2,474	45.20	1.06
$500,000	15,526	5,565	57.42	2.65
$1,000,000	15,246	10,841	69.42	5.75
$10,000,000	31,643	100,295	94.33	34.43
$50,000,000	6,231	122,222	99.24	69.37
Over $50,000,000	973	107,120	100.00	100.00
Total	127,046	$349,743	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–13.—Distribution of S Corporation, 1993: Transportation, Communication and Public Utilities

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	5,379	.....	7.00	.....
$25,000	21,452	$209	34.91	0.53
$50,000	13,168	486	52.04	1.77
$100,000	9,045	632	63.81	3.38
$250,000	9,951	1,569	76.76	7.37
$500,000	6,806	2,360	85.62	13.38
$1,000,000	4,578	3,269	91.57	21.70
$10,000,000	5,965	16,561	99.34	63.86
$50,000,000	460	9,347	99.93	87.65
$100,000,000	34	2,221	99.98	93.31
Over $100,000,000	17	2,630	100.00	100.00
Total	76,855	$39,284	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions	Cumulative percent	
			Returns	Gross receipts
$0	7,833	.....	10.19	.....
$2,500	2,233	$4	13.10	0.00
$5,000	118	0	13.25	0.01
$10,000	1,621	13	15.36	0.02
$25,000	5,088	94	21.98	0.14
$50,000	7,876	283	32.23	0.51
$100,000	11,726	896	47.49	1.68
$250,000	11,415	1,769	62.34	3.98
$500,000	9,651	3,363	74.90	8.36
$1,000,000	6,074	4,475	82.80	14.19
$10,000,000	11,944	31,596	98.34	55.34
$50,000,000	1,138	21,513	99.82	83.36
Over $50,000,000	137	12,776	100.00	100.00
Total	76,855	$76,781	.....	.....

Source: JCT calculations from IRS *Statistics of Income* date.

Table A–14.—Distribution of S Corporations, 1993: Wholesale and Retail Trade

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	33,066	.....	6.65	.....
$25,000	104,350	1,026	27.63	0.38
$50,000	63,476	2,343	40.39	1.24
$100,000	79,407	5,835	56.36	3.38
$250,000	92,118	15,028	74.88	8.89
$500,000	50,344	17,672	85.01	15.37
$1,000,000	29,379	20,609	90.92	22.92
$10,000,000	41,457	119,444	99.25	66.73
$50,000,000	3,458	62,335	99.95	89.59
$100,000,000	188	12,538	99.98	94.18
Over $100,000,000	79	15,860	100.00	100.00
Total	497,321	$272,690	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	31,156	.....	6.26	.....
$2,500	11,289	$14	8.53	0.00
$5,000	8,056	28	10.15	0.01
$10,000	10,357	79	12.24	0.06
$25,000	25,432	448	17.35	0.15
$50,000	23,670	886	22.11	0.44
$100,000	38,274	2,821	29.81	2.06
$250,000	91,037	15,482	48.11	5.01
$500,000	77,431	28,366	63.68	10.32
$1,000,000	71,556	50,942	78.07	37.37
$10,000,000	90,202	259,549	96.21	73.56
$50,000,000	16,554	347,173	99.54	100.00
Over $50,000,000	2,305	253,713	100.00	100.00
Total	497,321	$959,501	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–15.—Distribution of S Corporations, 1993: Finance Insurance and Real Estate

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	22,212	.....	7.75	.....
$25,000	72,154	$613	32.95	0.39
$50,000	25,933	955	42.00	0.99
$100,000	30,746	2,234	52.73	2.39
$250,000	48,842	8,015	69.79	7.44
$500,000	32,855	11,558	81.26	14.72
$1,000,000	25,453	18,024	90.14	26.08
$10,000,000	26,517	65,157	99.40	67.13
$50,000,000	1,539	29,217	99.94	85.53
$100,000,000	113	7,532	99.98	90.28
Over $100,000,000	65	15,435	100.00	100.00
Total	286,428	$158,740	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	153,503	.....	53.59	.....
$2,500	5,818	$5	55.62	0.01
$5,000	2,423	9	56.47	0.02
$10,000	5,172	36	58.28	0.08
$25,000	12,731	203	62.72	0.42
$50,000	12,827	458	67.20	1.18
$100,000	21,559	1,506	74.72	3.68
$250,000	31,380	4,966	85.68	11.93
$500,000	19,230	6,883	92.39	23.36
$1,000,000	10,308	7,047	95.99	35.07
$10,000,000	10,928	25,000	99.81	76.60
$50,000,000	490	8,476	99.98	90.68
Over $50,000,000	559	5,614	100.00	100.00
Total	286,428	$60,202	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–16.—Distribution of S Corporations, 1993: Services

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	46,656	.....	7.29	.....
$25,000	277,876	$2,372	50.71	1.89
$50,000	88,399	3,195	64.53	4.44
$100,000	78,482	5,542	76.79	8.85
$250,000	76,101	11,929	88.68	18.36
$500,000	32,794	11,493	93.81	27.52
$1,000,000	18,608	13,147	96.71	38.00
$10,000,000	19,959	49,587	99.83	77.53
$50,000,000	977	17,871	99.98	91.77
$100,000,000	71	5,003	100.00	95.76
Over $100,000,000	27	5,318	100.00	100.00
Total	639,950	$125,458	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	68,465	.....	10.70	.....
$2,500	19,715	$23	13.78	0.01
$5,000	15,263	59	16.16	0.03
$10,000	25,859	187	20.21	0.09
$25,000	48,339	811	27.76	0.38
$50,000	57,510	2,138	36.75	1.13
$100,000	88,184	6,213	50.53	3.32
$250,000	126,474	20,955	70.29	10.71
$500,000	84,279	29,601	83.46	21.15
$1,000,000	54,451	38,728	91.97	34.80
$10,000,000	48,547	115,890	99.55	75.65
$50,000,000	2,651	48,571	99.97	92.77
Over $50,000,000	212	20,504	100.00	100.00
Total	639,950	$283,680	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–17.—Distribution of Partnerships (1993)

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	61,663	.....	51.40	.....
$25,000	12,513	$117	61.83	0.29
$50,000	5,567	199	66.47	0.79
$100,000	7,474	554	72.71	2.18
$250,000	10,728	1,724	81.65	6.49
$500,000	8,246	2,912	88.52	13.77
$1,000,000	7,903	5,544	95.11	27.64
$10,000,000	5,520	13,097	99.71	60.39
$50,000,000	308	5,865	99.97	75.06
$100,000,000	20	1,310	99.98	78.34
Over $100,000,000	19	8,663	100.00	100.00
Total	119,960	$39,987	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	100,065	.....	83.42	.....
$2,500	1,433	$1	85.11	0.01
$5,000	602	2	85.65	0.03
$10,000	641	4	87.09	0.07
$25,000	1,737	28	90.55	0.34
$50,000	4,150	151	93.42	1.80
$100,000	3,443	269	97.03	4.40
$250,000	4,330	681	98.28	10.97
$500,000	1,490	515	99.11	15.94
$1,000,000	1,004	669	99.88	22.39
$10,000,000	921	2,353	99.98	45.09
$50,000,000	119	2,363	100.00	67.88
Over $50,000,000	25	3,329	100.00	100.00
Total	119,960	$10,364	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–18.—Distribution of Partnerships, 1993: Mining

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	6,619	.....	20.75	.....
$25,000	11,089	$95	55.52	0.17
$50,000	2,763	105	64.19	0.36
$100,000	2,034	152	70.57	0.63
$250,000	2,917	486	79.71	1.50
$500,000	1,926	674	85.75	2.70
$1,000,000	1,687	1,189	91.04	4.83
$10,000,000	2,312	6,898	98.29	17.15
$50,000,000	390	8,276	99.51	31.94
$100,000,000	69	4,558	99.73	40.08
Over $100,000,000	86	33,540	100.00	100.00
Total	31,892	$55,973	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	10,756	.....	33.73	.....
$2,500	2,834	$3	42.61	0.02
$5,000	1,944	7	48.71	0.06
$10,000	2,509	16	56.58	0.15
$25,000	3,522	58	67.62	0.48
$50,000	2,002	73	73.90	0.90
$100,000	2,755	202	82.53	2.06
$250,000	2,242	343	89.56	4.03
$500,000	1,261	455	93.52	6.64
$1,000,000	736	512	95.83	9.58
$10,000,000	1,106	2,986	99.29	26.72
$50,000,000	176	3,899	99.85	49.10
Over $50,000,000	47	8,868	100.00	100.00
Total	31,892	$17,421	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–19.—Distribution of Partnerships, 1993: Construction

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	33,491	.....	54.10	.....
$25,000	14,064	$116	76.81	0.64
$50,000	3,986	150	83.25	1.47
$100,000	1,347	96	85.43	2.00
$250,000	3,531	537	91.13	4.96
$500,000	2,094	742	94.51	9.05
$1,000,000	1,248	880	96.53	13.90
$10,000,000	1,934	5,754	99.65	45.63
$50,000,000	186	3,504	99.95	64.96
$100,000,000	19	1,356	99.98	72.43
Over $100,000,000	10	4,999	100.00	100.00
Total	61,910	$18,133	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	4,170	.....	6.74	.....
$2,500	521	$0	7.58	0.00
$5,000	1,356	5	9.77	0.02
$10,000	2,249	18	13.40	0.09
$25,000	5,996	98	23.09	0.45
$50,000	8,011	279	36.02	1.49
$100,000	10,616	808	53.17	4.50
$250,000	15,970	2,520	78.97	13.88
$500,000	6,778	2,368	89.92	22.69
$1,000,000	3,227	2,287	95.13	31.20
$10,000,000	2,681	7,059	99.46	57.48
$50,000,000	281	5,789	99.91	79.03
Over $50,000,000	55	5,635	100.00	100.00
Total	61,910	$26,867	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–20.—Distribution of Partnerships, 1993: Manufacturing

Firms classified by assets less than	Number of returns	Total assets (millions	Cumulative percent	
			Returns	Total assets
$0	8,781	.....	35.03	.....
$25,000	4,850	$29	54.38	0.03
$50,000	2,682	97	65.08	0.14
$100,000	2,406	170	74.68	0.33
$250,000	2,521	428	84.74	0.81
$500,000	1,116	395	89.19	1.25
$1,000,000	597	408	91.57	1.70
$10,000,000	1,361	4,737	97.00	6.99
$50,000,000	483	11,116	98.93	19.41
$100,000,000	109	7,651	99.37	27.95
Over $100,000,000	159	64,521	100.00	100.00
Total	25,065	$89,551	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	1,432	.....	5.71	.....
$2,500	1,771	$2	12.78	0.00
$5,000	1,054	5	16.98	0.01
$10,000	2,066	15	25.23	0.02
$25,000	2,911	52	36.84	0.08
$50,000	1,170	48	41.51	0.13
$100,000	3,106	217	53.90	0.37
$250,000	3,958	615	69.69	1.03
$500,000	3,462	1,251	83.50	2.39
$1,000,000	1,438	983	89.24	3.46
$10,000,000	1,884	5,766	96.76	9.71
$50,000,000	512	11,630	98.80	22.33
Over $50,000,000	302	71,587	100.00	100.00
Total	25,065	$92,169	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–21.—Distribution of Partnerships, 1993: Transportation, Communication and Public Utilities

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	5,514	.....	26.56	.....
$25,000	5,781	$68	54.42	0.06
$50,000	1,795	65	63.06	0.12
$100,000	990	74	67.83	0.19
$250,000	2,340	353	79.11	0.52
$500,000	713	242	82.54	0.75
$1,000,000	670	491	85.77	1.21
$10,000,000	1,789	6,581	94.39	7.35
$50,000,000	689	16,010	97.71	22.30
$100,000,000	231	16,585	98.82	37.78
Over $100,000,000	245	66,634	100.00	100.00
Total	20,757	$107,103	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	5,006	.....	24.12	.....
$2,500	343	$1	25.77	0.00
$5,000	343	1	27.42	0.00
$10,000	497	5	29.82	0.01
$25,000	1,574	27	37.40	0.06
$50,000	2,349	84	48.72	0.20
$100,000	2,926	214	62.81	0.56
$250,000	3,195	528	78.20	1.45
$500,000	1,092	391	83.47	2.12
$1,000,000	926	642	87.93	3.20
$10,000,000	1,738	5,808	96.30	13.03
$50,000,000	601	13,204	99.20	35.39
Over $50,000,000	167	38,167	100.00	100.00
Total	20,757	$59,071	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–22.—Distribution of Partnerships, 1993: Wholesale and Retail Trade

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	70,598	.....	44.92	.....
$25,000	27,770	$286	62.58	0.45
$50,000	13,939	511	71.45	1.25
$100,000	15,605	1,120	81.38	3.01
$250,000	15,138	2,391	91.01	6.77
$500,000	7,423	2,576	95.73	10.82
$1,000,000	3,198	2,163	97.77	14.21
$10,000,000	3,012	8,677	99.69	27.85
$50,000,000	413	8,068	99.95	40.52
$100,000,000	35	2,351	99.97	44.22
Over $100,000,000	49	35,503	100.00	100.00
Total	157,178	$63,646	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	6,362	.....	4.05	.....
$2,500	13,099	$13	12.38	0.01
$5,000	5,822	21	16.09	0.03
$10,000	8,531	62	21.51	0.09
$25,000	13,171	220	29.89	0.28
$50,000	15,136	578	39.52	0.80
$100,000	22,396	1,652	53.77	2.27
$250,000	29,658	4,849	72.64	6.60
$500,000	18,653	6,605	84.51	12.49
$1,000,000	12,545	8,942	92.49	20.46
$10,000,000	10,657	25,107	99.27	42.86
$50,000,000	917	19,518	99.85	60.27
Over $50,000,000	232	44,546	100.00	100.00
Total	157,178	$112,112	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–23.—Distribution of Partnerships, 1993: Finance, Inusrance and Real Estate

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	176,744	.....	22.30	.....
$25,000	46,781	$478	28.20	0.03
$50,000	38,731	1,501	33.09	0.12
$100,000	59,635	4,435	40.61	0.40
$250,000	120,827	19,766	55.85	1.64
$500,000	97,288	34,762	68.13	3.81
$1,000,000	88,891	63,343	79.34	7.76
$10,000,000	142,895	411,667	97.37	33.47
$50,000,000	17,218	341,795	99.54	54.82
$100,000,000	1,984	136,854	99.79	63.37
Over $100,000,000	1,658	586,506	100.00	100.00
Total	792,651	$1,601,107	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	735,158	.....	92.75	.....
$2,500	6,010	$6	93.50	0.01
$5,000	1,999	6	93.76	0.02
$10,000	3,413	25	94.19	0.06
$25,000	6,216	104	94.97	0.23
$50,000	5,448	203	95.66	0.55
$100,000	6,413	451	96.47	1.28
$250,000	10,093	1,683	97.74	3.98
$500,000	6,348	2,234	98.54	7.57
$1,000,000	4,489	3,172	99.11	12.67
$10,000,000	6,272	17,620	99.90	41.00
$50,000,000	694	13,074	99.99	62.02
Over $50,000,000	98	23,623	100.00	100.00
Total	792,651	$62,200	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

Table A–24.—Distribution of Partnerships, 1993: Services

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent	
			Returns	Total assets
$0	100,237	.....	38.83	.....
$25,000	63,300	$534	63.35	0.30
$50,000	18,079	658	70.35	0.66
$100,000	17,457	1,239	77.11	1.35
$250,000	22,383	3,658	85.78	3.39
$500,000	11,032	3,826	90.06	5.52
$1,000,000	8,277	5,813	93.26	8.76
$10,000,000	14,943	44,652	99.05	33.62
$50,000,000	1,945	41,118	99.81	56.51
$100,000,000	288	20,285	99.92	67.80
Over $100,000,000	213	57,827	100.00	100.00
Total	258,154	$179,610	.....	.....

Firms classified by gross receipts less than	Number of returns	Gross receipts (millions)	Cumulative percent	
			Returns	Gross receipts
$0	42,429	.....	16.44	.....
$2,500	15,107	$17	22.29	0.01
$5,000	9,752	35	26.07	0.03
$10,000	9,748	69	29.84	0.06
$25,000	24,632	416	39.38	0.29
$50,000	24,673	905	48.94	0.77
$100,000	27,573	2,012	59.62	1.84
$250,000	39,175	6,333	74.80	5.22
$500,000	24,241	8,516	84.19	9.76
$1,000,000	17,610	12,483	91.01	16.41
$10,000,000	20,965	53,976	99.13	45.19
$50,000,000	1,849	37,153	99.85	64.99
Over $50,000,000	400	65,673	100.00	100.00
Total	258,154	$187,588	.....	.....

Source: JCT calculations from IRS *Statistics of Income* data.

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